

***United States Court of Appeals
for the Second Circuit***



APPENDIX

Docket No.

76-4199

UNITED STATES COURT OF APPEALS for the
SECOND CIRCUIT

-----X
ANGELO J. and IDA A. BIANCHI,
Petitioners-Appellants,

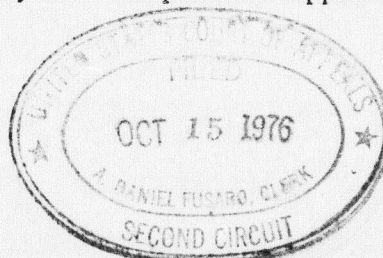
v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.
-----X

APPENDIX

WINTHROP DRAKE THIES
Attorney for Petitioners-Appellants
62 Halsted Street
East Orange, New Jersey 07019
Tel: 201/676-9300

TO: Court of Appeals for the Second Circuit, Attn: Clerk
Scott P. Crampton, Esq., Ass't Attorney General, Tax Div.,
U.S. Department of Justice, Attorney for Respondent-Appellee



PAGINATION AS IN ORIGINAL COPY

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UNITED STATES TAX COURT

GENERAL DOCKET

(Amd. 1/22/76)

DOCKET NO. 8152-74

ANGELO J. BIANCHI AND IDA ^{A.} BIANCHI
935 Clinton Avenue North
Rochester, New York 14621 PETITIONER,
 VS.
 COMMISSIONER OF INTERNAL REVENUE,
 RESPONDENT.

APPEARANCES FOR PETITIONER: Winthrop Drake Thies
 62 Halsted Street, East Orange, New Jersey
 07019

NAME _____
 ADDRESS _____

Date Month Day Year			Filings and Proceedings	Action	Served
Oct. 8, 1974			PETITION FILED: FEE PAID		Oct. 9, 1974
Dec. 5, 1974			REQUEST by Resp. for Trial at Buffalo, N.Y.	GRANTED Dec. 6, 1974	Dec. 6, 1974
Dec. 5, 1974			ANSWER by Resp. filed.		Dec. 6, 1974
June 27, 1975			NOTICE OF TRIAL on Oct. 6, 1975 at Buffalo, N.Y.		June 27, 1975
Oct. 6, 7, 1975			TRIAL at Buffalo, N.Y. before Judge Goffe.		
			Stip. of Facts with exhibits attached filed 10/7/75		
			SIMULTANEOUS		
			ORIGINAL BRIEFS DUE: Nov. 21, 1975		
			REPLY BRIEFS DUE: Dec. 22, 1975		
			SUBMITTED TO JUDGE GOFFE		
Oct. 31, 1975			TRANSCRIPT of Oct. 7, 1975 received.		
Nov. 19, 1975			MOTION by Petr. to extend time to Dec. 22, 1975 and	GRANTED Nov. 20, 1975	NOV 20 1975
			Jan. 21, 1976 for filing Original Briefs and Reply		
			Briefs, Respectively.		
Dec. 22, 1975			BRIEF for the Respondent filed.		DEC 23 1975 DEC 23 1975
Dec. 22, 1975			BRIEF for the Petitioner filed.		
Jan. 21, 1976			REPLY BRIEF for Resp. filed.		JAN 26 1976
Jan. 22, 1976			ORDER, that the caption of this case is amended.		JAN 23 1976
Jan. 26, 1976			REPLY BRIEF for Petr. filed. (P.M. Timely)		JAN 26 1976
May 20, 1976			FINDINGS OF FACT AND OPINION filed, Judge Goffe.		MAY 20 1976
			Decision will be entered for the respondent.		

(Continued on page 2)

Form No. 34
May 1970

UNITED STATES TAX COURT

-----x
ANGELO J. BIANCHI, D.D.S., and
IDA J. BIANCHI,
 Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,
 Respondent
-----x

:
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:
:
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:
:
: Docket No.
:
:
:-----x

1. The petitioners are Angelo J. Bianchi, D.D.S., and Ida J. Bianchi, man and wife, both residing at 1935 Clinton Avenue North, Rochester, New York 14621, who filed a joint income tax return for their taxable year ended December 31, 1970, being the tax period in controversy, with the Buffalo, N.Y., District Director.

2. The notice of deficiency to which this petition responds is dated July 10, 1974, and was received by petitioners on or about July 15, 1974. The precise date of mailing is unknown to them, no postmark having been impressed on the envelope. The "Tax Year Ended" is incorrect in such notice: apparently "12/21/70" was put down through clerical error when "12/31/70" was intended.

3. The Commissioner determined a deficiency of \$9,554.75 on account of petitioners' personal income tax for the taxable year ended December 31, 1970.

4. The Commissioner erred in determining such deficiency in the following respects:

- a) The pension plan adopted by Angelo J. Bianchi, P.C., then a Subchapter S corporation, and in force for the corporate year ending within the tax year in issue of petitioners met the requirements of Sec. 401(a) of the Internal Revenue Code of 1954, as amended.

- b) Said plan required a corporate contribution in each taxable year of the corporation of \$16,993.41.
- c) Said plan, setting forth such contemplated annual contribution, was granted a favorable determination letter by the Buffalo District Director.
- d) The \$16,993.41 required contribution was made within the taxable year of the corporation, producing a net operating loss to the corporation of \$16,946.11.
- e) Angelo J. Bianchi, DDS, was at all times the sole stockholder of said Subchapter S corporation and properly took such \$16,946.11 loss into account on the joint return in issue.
- f) The compensation actually paid to corporate employees, whether considered individually or collectively and whether the pension plan prospective benefits be considered a part of current compensation as a matter of good law or not, was in all respects "reasonable".
- g) There is no basis at law or under the settled practices of the Internal Revenue Service, which practices are absolutely to the contrary, to reduce or partially disallow a pension contribution made within a short taxable year: under the level annual funding method used here and by most taxpayers, pension contributions should be equal in each tax year, whether or not it is a short year.

5. The facts on which petitioners rely to sustain the above-cited assignments of error are as follows:

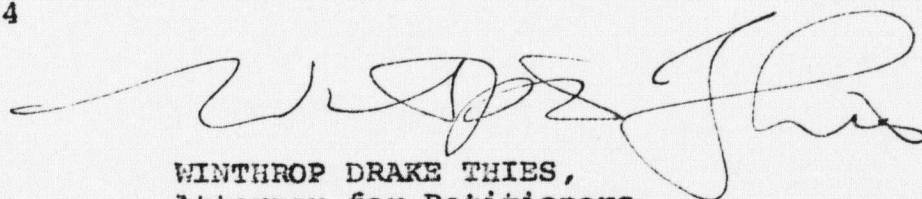
- a. Angelo J. Bianchi, P.C. was a valid and existing corporation for its fiscal year ended November 30, 1970, the stock of which was at all times relevant owned by petitioner Angelo J. Bianchi, DDS.
- b) For such year it had in force a valid Subchapter S election.
- c) It enacted within such year a "qualified" pension plan to which the District Director in due course gave a fully favorable determination letter.
- d. Said plan by its terms required a \$16,993.41 contribution for such tax year.
- e. Such contribution was made on or before November 30, 1970.

- f. Such contribution, in the context of the corporation's other income and deductions, produced a net operating loss of \$16,946.11 for the corporate year ended November 30, 1970.
- g. Petitioners properly took such loss into account as a deduction on their return here in issue.
- h. The compensation paid corporate employees was in all respects "reasonable", whether such employees be considered individually or collectively and whether the prospective pension benefits be regarded as current compensation or not.
- i. There as no "negligence" by petitioners in respect to this pension matter, the treatment adopted having been done on the advice of skilled pension consultants and accountants.

WHEREFORE, it is prayed that this Court try the case and that the deficiency determined by the Commissioner be set aside in its entirety and that it be determined that the petitioners

have no additional liability for personal income taxes for the tax year in issue, nor for negligence penalties nor interest.

October 4, 1974



WINTHROP DRAKE THIES,
Attorney for Petitioners
62 Halsted Street
East Orange, New Jersey 07019

Tel. (201) 676-9300

Address any reply to APPELLATE DIVISION at: 300 U.S. Court House, Buffalo, NY 14202
Department of the Treasury

Regional Commissioner
Internal Revenue Service
North-Atlantic Region

Date:

JUL 10 1974

In reply refer to:

AP:BUF:AHO



Mr. Angelo J. Bianchi and
Mrs. Ida A. Bianchi
1935 Clinton Avenue North
Rochester, New York 14621

Dear Mr. and Mrs. Bianchi:

Tax Year Ended	Deficiency	Addition to Tax, Sec. 6653(a)
12/21/70	\$9,554.75	\$477.74

This letter is a **NOTICE OF DEFICIENCY**—as required by law—that we have determined the income tax deficiencies shown above. I regret we have been unable to reach a satisfactory agreement in your case. The enclosed statement shows how the deficiencies were computed.

If you do not intend to contest this determination in the United States Tax Court, please sign and return the enclosed waiver form. This will permit an early assessment of the deficiencies and limit the accumulation of interest. The enclosed self-addressed envelope is for your convenience.

If you decide not to sign and return the waiver, the law requires that after 90 days from the date of mailing this letter (150 days if this letter is addressed to you outside the United States and the District of Columbia) we assess and bill you for the deficiencies. However, if within the time stated you contest this determination by filing a petition with the United States Tax Court, Box 70, Washington, D.C. 20044, we may not assess any deficiencies and bill you until after the Tax Court has decided your case. You may obtain a copy of the rules for filing a petition by writing to the Clerk of the Tax Court at the Court's Washington, D.C. address.

If you intend to file a petition with the United States Tax Court, you must do so within the time stated above (90 or 150 days, as the case may be); this period is fixed by law, and the Court cannot consider your case if your petition is filed late.

Sincerely yours,
Donald C. Alexander ~~XXXXXXXXXXXX~~
Commissioner

By

Andrew H. Olson

Andrew H. Olson
Appellate Conferee

Enclosures:
Statement
Waiver, Form 870
Envelope

6

FORM 4089
(REV. MAY 1970)

DEPARTMENT OF THE TREASURY - INTERNAL REVENUE SERVICE

SYMBOLS

STATUTORY NOTICE STATEMENT

AP:BUF:AHO:SJP

Mr. Angelo J. Bianchi and
Mrs. Ida A. Bianchi
1935 Clinton Avenue North
Rochester, New York 14621

KIND OF TAX

Income

TAX YEAR ENDED	Tax	DEFICIENCY	Addition to the Tax Sec. 6653(a)
December 31, 1970	\$9,554.75		\$477.74

It is determined that part of the underpayment of tax for the taxable year ended December 31, 1970, is due to negligence or intentional disregard of rules and regulations. Consequently, the 5 per centum addition to the tax provided by section 6653(a) is asserted for that year.

☐ Copy to Authorized Representative:

Winthrop Drake Thais, Esq.
62 Halsted Street
East Orange, New Jersey 07019

INDIVIDUAL INCOME TAX

STATEMENT SCHEDULE

1

NAME

Angelo J. and Ida A. Bianchi

TAXABLE YEARS ENDED

12/31/70

TAXABLE INCOME OR ADJUSTED GROSS INCOME AS SHOWN IN:

- ☒ RETURN AS FILED
☐ PRELIMINARY LETTER DATED
☐ STATUTORY NOTICE DATED

\$48,581.70

INCREASES (DECREASES) IN INCOME: (See attached explanation of items)

(a) 1120-S Income re:
A. J. Bianchi Prof. Corp.

16,667.52

(b) Form 4087:
Schedule #2

15,903.07

TAXABLE INCOME AS REVISED OR ADJUSTED GROSS INCOME AS REVISED

81,152.29

TAX COMPUTATION

TAX

34,008.33

TAX SURCHARGE

850.21

TAX PLUS SURCHARGE

34,858.54

LESS: TAX CREDITS

SUBTOTAL

34,858.54

ADD:

SELF-EMPLOYMENT TAX

212.23

TAX FROM RECOMPUTING PRIOR YEAR INVESTMENT CREDIT

--

TAX LIABILITY

35,070.77

LIABILITY PREVIOUSLY ASSESSED

16,971.85

8,544.17

25,516.02

DEFICIENCY (Overassessment)

9,554.75

Addition to the tax

Sec. 6653(a):

5% of \$ 18,098.92

\$ 904.95

Assessed

427.21

Deficiency, Sec. 6653(a) addition

\$ 477.74

FORM 4087
JUNE 1967

U. S. TREASURY DEPARTMENT - INTERNAL REVENUE SERVICE

STATEMENT SCHEDULE

ADJUSTMENTS TO INCOME
(Supplemental Schedule)

2

NAME

Angelo J. and Ida A. Bianchi

TAXABLE YEAR ENDED

12/31/70

INCREASES (DECREASES) IN INCOME:

- (1) Sales Tax
- (2) Gross Receipts
- (3) Depreciation
- (4) Insurance
- (5) Dues, Misc. Gen. Exp.

\$ 454.77
15,039.75
10.25
403.53
(5.23)

NET INCREASE (DECREASE) IN INCOME
TO STATEMENT SCHEDULE

15,903.07

EXPLANATION OF ITEMS

SCHEDULE NO. OR
EXHIBIT

3

NAME OF TAXPAYER

YEAR/PERIOD ENDED

Angelo J. and Ida A. Bianchi

12/31/70

(a) On your income tax return for 1970 you claimed a net operating loss of Angelo J. Bianchi, P.C., an electing small business corporation, in the amount of \$16,946.11. It is determined that the allowable deduction of such corporation for a contribution paid by an employer to or under its pension plan during its taxable year ended November 30, 1970, is \$325.89 (as computed below) since such amount, together with other deductions allowed for compensation for employees covered by the plan, constitutes a reasonable allowance for compensation for services actually rendered. Accordingly, it is determined that the net operating loss of Angelo J. Bianchi, P.C., for the taxable year ended November 30, 1970, is \$278.59 and that you are entitled to a net operating loss deduction of \$278.59 rather than \$16,946.11 as claimed on your return.

Computation of allowable deduction of Angelo J. Bianchi, P.C. for contribution to its pension plan.

$$7/365 \times \$16,993.41 = \$325.89$$

EXPLANATION OF ITEMS

SCHEDULE NO. OR
EXHIBIT

4

NAME OF TAXPAYER

Angelo J. and Ida A. Bianchi

YEAR/PERIOD ENDED

12/31/70

(b) Adjustments 1 - 5, inclusive listed on Form 4087, Schedule #2, are agreed:

1. Sales taxes claimed \$ 1,090.89

Sales taxes allowed 636.12

Sales taxes disallowed \$ 454.77

2. Gross receipts determined from records \$113,187.30

Gross receipts reported 98,147.55

Understatement \$ 15,039.75

3. Depreciation claimed on equipment \$ 70.64

Depreciation allowed 60.39

Overstatement \$ 10.25

4. Insurance expense claimed \$ 881.12

Insurance expense allowed 477.59

Overstatement \$ 403.53

5. Dues, Misc. General Expense Claimed \$ 1,159.95

Dues, Misc. General Expense Allowed 1,165.18

Understatement (\$ 5.23)

Adjustments 1 - 5 inclusive, listed on Form 4087, Schedule #2, are agreed.

FILED
UNITED STATES TAX COURT

1974 DEC 5 PM 3 22

ANGELO J. BIANCHI, and
IDA J. BIANCHI,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

UNITED STATES
TAX COURT

Dkt. No. 8152-74

ANSWER

THE RESPONDENT, in answer to the petition filed in the above-entitled case, admits, denies and alleges as follows:

1. Admits the allegations of paragraph 1 of the petition.
2. Admits that the notice of deficiency was mailed to petitioners on July 10, 1974, and that the tax in question is income tax for the year ended December 31, 1970. Denies the remaining allegations of paragraph 2 of the petition.
3. Admits the allegations of paragraph 3 of the petition. Alleges that respondent also determined additions to the tax under Internal Revenue Code of 1954 §6653(a) for petitioners' taxable year ended December 31, 1970. Alleges that not all of the amounts set forth above and in paragraph 3 of the petition are in controversy.
4. (a) through (g). Denies the allegations of error of subparagraphs (a) through (g) of paragraph 4 of the petition.

SERVED DEC 6 1974

5. (a) through (c). Admits allegations of subparagraphs (a) through (c) of paragraph 5 of the petition.

~~(d)~~ (d) Denies allegations of subparagraph (d) of paragraph 5 of the petition.

(e) Admits allegations of subparagraph (e) of paragraph 5 of the petition.

(f) through (i). Denies the allegations of subparagraphs (f) through (i) of paragraph 5 of the petition.

6. Denies generally each and every allegation of the petition not hereinbefore admitted, qualified or denied.

WHEREFORE, it is prayed that the deficiency determined by the respondent be in all respects approved.

MEADE WHITAKER
Chief Counsel
Internal Revenue Service

By: STEPHEN M. MILLER
Assistant Regional Counsel

Date:

OF COUNSEL: DEC 3 1974

MARVIN E. HAGEN
Regional Counsel
BERNARD R. BAKER III
Attorney
Internal Revenue Service
304 U. S. Courthouse
Buffalo, N. Y. 14202
TEL. No. 716-842-5774

UNITED STATES TAX COURT

ANGELO J. BIANCHI, and
IDA J. BIANCHI,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

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Dkt. No. 8152-74

STIPULATION OF FACTS

It is hereby stipulated that for the purpose of this case the following statements may be accepted as facts and all exhibits referred to herein and attached hereto are incorporated in this stipulation and made a part hereof, subject to the right of either party to object to the admission of such facts in evidence on the grounds of materiality and relevancy; provided, however, that either party may introduce other and further evidence not inconsistent with the facts herein stipulated.

1. The petitioners' residence at the time they filed their petition herein was 1935 Clinton Avenue North, Rochester, New York 14621.

2. The petitioners timely filed their 1970 Federal income tax return (Form 1040) with the Andover Service Center, Andover, Massachusetts. Attached hereto and marked joint exhibit 1-A is a copy of said filed return.

3. On November 23, 1970, Angelo J. Bianchi, P.C., a professional service corporation was organized pursuant to the provisions of Art. 15 of the N.Y. Bus. Corp. Law (McKinney Supp. 1974). All of the stock of such corporation is now owned and has always been owned by Angelo J. Bianchi.

4. On November 27, 1970, the Andover Service Center received Form 2553 (Election By Small Business Corporation) filed by Angelo J. Bianchi, P.C., (hereinafter referred to as the CORPORATION).

5. On November 24, 1970, Angelo Bianchi, as president of the CORPORATION executed an Employees' Pension Trust Agreement. Pursuant to said Agreement a trust account (#05-05943-1) was opened on November 27, 1970, at the Bankers Trust Co., Rochester, New York. The pension plan and trust agreement of the CORPORATION are adoptions of a Master or Prototype Pension or Annuity Plan (Serial #1701843) submitted to the Internal Revenue Service by Security Mutual Life Insurance Company of New York, 80 Exchange Street, Binghamton, New York 13902, and approved on April 22, 1970. Attached hereto and marked joint exhibit 2-B is a copy of the master prototype plan and the approval letter dated April 22, 1970.

6. On November 30, 1970, the CORPORATION deposited the sum of \$16,993.41 in the trust account at Bankers Trust Co.

7. A Form 1120-S (U.S. Small Business Corporation Income Tax Return) for the short taxable year November 23 - November 30, 1970, was filed by the CORPORATION with the Andover Service Center on February 18, 1971. A copy of said return is attached hereto and marked joint exhibit 3-C.

8. On March 16, 1971, the District Director's office at Buffalo, New York, received an Application For Determination (Form 4462) relative to the adoption of the previously approved master or prototype form of Pension or Annuity Plan of Security Mutual Life Insurance Company of New York. Attached hereto and marked joint exhibit 4-D is a copy of said Form 4462 dated March 4, 1971. On April 20, 1971, the District Director by a form letter informed the CORPORATION that the plan qualified under either Int. Rev. Code of 1954, § 401 or § 405.

9. The CORPORATION submitted a Form 2950 (Statement in Support of Deduction) relative to the pension plan contribution of \$16,993.41 claimed as a deduction on the Form 1120-S for the short taxable year November 23 - November 30, 1970. Attached hereto and marked joint exhibit 5-E is a copy of said Form 2950.

10. Angelo Bianchi was born on September 17, 1920.

11. Dr. Bianchi graduated from the Dental College of the University of Buffalo in 1949 and thereafter did an internship at the Eastman Dental Center, Rochester, N.Y. until 1950.

12. After one year in private practice he enrolled in St. Mary's Hospital, Rochester, New York, for a full-time one-year course in general anesthesia.

13. Following that he worked at Mt. Morris Tuberculosis Hospital, Mt. Morris, New York, for a period of 17 years administering general anesthesia for all types of surgical procedures while at the same time maintaining his dental practice.

14. For about the past 25 years Dr. Bianchi participated in the programs of continuing education of the

Rochester Dental Society. Additionally, he has attended the annual University of Buffalo Dental Seminars since their inception some 15 to 20 years ago.

15. Prior to 1970 he took crown and bridge courses and a course in implantology at the Institute of Graduate Dentists, located at New York, New York.

16. Dr. Bianchi's practice and his services to the CORPORATION were and are a practice of general dentistry with heavy emphasis on crown and bridge work. The only phase of general dentistry in which little work is done is the field of orthodontia.

17. Dr. Bianchi's Schedules C of his Federal income tax returns showed the following net profit from his dentistry practice:

Per Schedule C

<u>Year</u>	<u>Net Profit From Profession</u>
1964	\$47,620.00
1965	38,039.00
1966	53,246.00
1967	62,450.00
1968	72,735.00
1969	75,702.00
1970	65,570.31*

* This figure was adjusted to \$81,473.00 per the adjustments set forth in the statutory notice, and is for the period January 1, 1970 through November 23, 1970.

18. His wages from the CORPORATION for its first short taxable year November 23 - November 30, 1970, were \$923.08, while his wages from the CORPORATION for the month of December 1970 were \$3,692.32.

19. In later periods his wages from the CORPORATION were as follows:

<u>Calendar Year</u>	<u>Wages</u>
1971	\$48,000.16
1972	48,223.24
1973	48,000.16
1974	58,000.16

20. The CORPORATION's taxable income, or loss, per filed Federal corporate tax returns, was as follows:

<u>Taxable Year Ended Nov. 30</u>		<u>Taxable Income</u>
1970	Loss	(\$16,946.11)
1971	Income	16,113.93
1972	Income	13,027.39
1973	Income	8,707.05
1974	Income	3,915.97

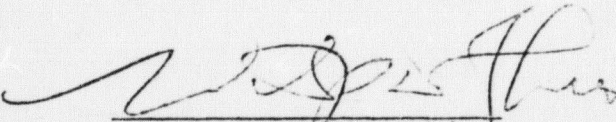
21. The pension contributions of the CORPORATION as claimed on the CORPORATION's income tax returns allocable to Dr. Bianchi were as follows:

<u>Taxable Year Ended Nov. 30</u>	<u>Amount of Contribution Allocable to Dr. Bianchi</u>
1970	\$16,469.88
1971	17,023.82
1972	16,003.16
1973	16,900.24
1974	21,931.85

MEADE WHITAKER
Chief Counsel
Internal Revenue Service

By: (Sgd) Stephen M. Miller

Stephen M. Miller
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304 U. S. Courthouse
Niagara Square
Buffalo, New York
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Winthrop Drake Thies
Counsel for Petitioners
62 Halsted Street
East Orange, New Jersey 07019
Tel. No. 201-676-9300

Date: OCT 7 1975

UNITED STATES TAX COURT

ANGELO J. and IDA J. BIANCHI

Petitioner

vs

COMMISSIONER OF INTERNAL REVENUE

Respondent

DOCKET NO. 8152-74

LOCATION OF HEARING: Buffalo, New York

DATE: October 7, 1975

BEFORE: Honorable William A. Goffe

APPEARANCES: Winthrop Drake Thies
Attorney for PetitionerJohn White
Attorney for Respondent

P R O C E E D I N G S

THE CLERK: Be seated.

THE COURT: Will the Clerk call the next case, please?

THE CLERK: Yes, Your Honor. Docket No. 8152-74, Angelo J. Bianchi and Ida J. Bianchi. Would you state your appearances for the record, please?

MR. THIES: For the Petitioner, Winthrop Drake Thies.

MR. WHITE: Your Honor, John White for the Respondent. And, Your Honor, at this time I'd like to request the Court to have Mr. Ken Bersani as associate counsel for the government in this case. Mr. Bersani is awaiting admission to the State Bar, and upon being duly sworn by the State Court, will apply for admission -- for enrollment to practice before the Tax Court.

THE COURT: Permission will be granted to have him appear for that purpose in this case.

MR. WHITE: Thank you, Your Honor.

THE COURT: Would the parties offer the Stipulation of Facts at this time?

MR. WHITE: Your Honor, at this time I would like to offer a Stipulation of Facts, with attached exhibits 1-A -- Joint Exhibits 1-A through Joint Exhibits 5-E.

1 THE COURT: The Stipulation of Facts, together
2 with Joint Exhibits 1-A through 5-E, inclusive, will be
3 received in evidence and made a part of the record.

4 MR. WHITE: Thank you, Your Honor.

5 THE COURT: Mr. Thies, would you like to make
6 your opening statement?

7 MR. THIES: Yes, I would, Your Honor. The peti-
8 tioners in this case are Angelo J. Bianchi, D.D.S., and
9 his wife, Ida Bianchi. The year in issue for their per-
10 sonal Federal Income Tax Return is 1970 -- the calendar
11 year 1970. The issue in this case involves the propriety,
12 as a matter of good Federal Income Tax law, of a claimed
13 deduction of nearly \$17,000.00 for a pension contribution
14 made by the professional corporation owned entirely by
15 Dr. Bianchi. This pension contribution, if allowed in
16 full, would produce a net operating loss. It is our con-
17 tention that that is appropriate, and as a matter of good
18 law, the doctor is entitled to claim, as he did, the net
19 operating loss as a deduction in his personal Income Tax
20 Return filed jointly with his wife. As I see it, there
21 are three basic issues of law, which I'm not going to dis-
22 cuss in detail. They'll be left to the briefs, but to be
23 helpful to this Court, they're set out in trial memorandum.
24 The first one is, as a matter of pension law, both good
25 pension administration and Federal Income Tax law, Sections

1 404 and Section 162 of the Code, is this entire pension
2 contribution deductible by the corporation? It is our con-
3 tention that it is, under Section 404. Secondly, since
4 statutorily Section 162 does control, admittedly -- does
5 put a further limitation -- what is the effect of Section
6 162? To what extent was this entire \$17,000.00 an ordinary
7 and necessary cost of doing business to the dental corpora-
8 tion. We feel, and the testimony will show, that it was
9 entirely ordinary and necessary. The third point of law is
10 one that is contested. It's the government's settled
11 position, and we think in error, that in the event of any
12 contribution to a qualified plan, the amount allocable to
13 the account of a particular participant in the plan is to
14 be added to his direct compensation, for instance, his
15 salary for that year, in deciding an issue of reasonable
16 compensation. In other words, although the Code does not
17 explicitly say it, the government argues that not alone is
18 162 an explicit limitation on Section 404. That 162(a)1,
19 the reasonable compensation for services actually rendered
20 is an additional, Congressionally unstated, but understood
21 limitation on the 404 deduction. It is our contention
22 that that's wrong, as a matter of law, but necessarily not
23 to leave a gap in the presentation of our case, we're going
24 to meet that issue and show that even were this the law,
25 that as a matter of fact, since a reasonable compensation

1 issue is always a matter of fact, ultimately, that in this
2 case the compensation was not unreasonable. Not unreasonably
3 high, even when the pension contribution is added. And,
4 we have an expert witness that will so testify. Let me
5 briefly advert to the witnesses who will appear. The
6 petitioner, Angelo J. Bianchi, D.D.S. will appear and tes-
7 tify as to the facts surrounding the adoption of the pension
8 plan in issue, the short first fiscal year, and the con-
9 tribution. Then, a pension consultant, Philip J.
10 Cichanowicz, C.L.U., will appear and explain his role as
11 pension consultant to the corporation in designing and in-
12 stalling this pension, and he will also, to the extent,
13 Your Honor would appreciate it, will go into pensions as an
14 expert witness, and will explain how this plan was funded
15 and the method of funding the future cost. Finally, we
16 have an expert witness on the compensation of dentists in
17 the Rochester area. Peter A. Carillo, D.D.S., president of
18 the Monroe County Dental Society, has kindly consented to
19 appear, and he will, from his twenty years experience in
20 the economics of the dental profession, advise this Court
21 of standards of earnings and pension plans of professional
22 corporations in the Rochester area, and will show that the
23 pension plan in issue was ordinary and necessary, and that
24 the doctor's compensation, on a historical basis, was, if
25 anything, not high, but low. That he was undercompensated

1 in view of his education, training, skill and experience.
2 That having been done, Your Honor, that will be our case.

3 THE COURT: Thank you, Mr. Thies. Mr. White?

4 MR. WHITE: Your Honor, this case involves the
5 year 1970, and it also involves not only an Income Tax
6 deficiency, but a 5% negligence penalty. And, I believe
7 that that penalty is still in issue. The underlying issue
8 in the case, Your Honor, is whether or not the petitioners
9 are entitled to a net operating loss from the professional
10 corporation, Angelo J. Bianchi, P.C., in the amount of
11 \$16,946.11 as claimed, or \$278.59 as allowed by respondent.
12 As indicated in the Stipulation of Facts, this corporation
13 was only in existence for nine days -- I mean -- I'm sorry,
14 Your Honor, seven days, from November 23 to November 30,
15 1970. During that one week period, Dr. Bianchi's wages
16 which were actually paid to him were \$923.08. That being
17 the gross amount of the wages. And, during that same
18 period, the contribution to the pension plan, which was for
19 the benefit of Dr. Bianchi, totaled \$16,470.00. It is our
20 position, Your Honor, that the deduction of the contribu-
21 tion made to the employer's pension fund must satisfy the
22 conditions of deductibility as set forth in Section 162.
23 And it is our further position that since a contribution
24 to a pension plan is compensation, such compensation must,
25 in addition to the non-deferred or the direct wage payments

1 must be considered collectively in determining whether or
2 not the total compensation is reasonable. It is our posi-
3 tion, Your Honor, that the compensation attributable to
4 Dr. Bianchi during the seven day period, which would in-
5 clude the wages and his portion of the contribution to the
6 pension plan, is excessive for the services which he ac-
7 tually rendered to the corporation during this seven day
8 period. And, as Mr. Thies stated, it is our position that
9 you can't take into account the compensation of all em-
10 ployees as a group, but you have to look at the compensation
11 of each employee separately in determining the reasonableness
12 or the unreasonableness of such compensation. It is further
13 our position, Your Honor, that in determining the amount of
14 the pension plan contribution, none of the services which
15 were rendered by Dr. Bianchi, as the sole proprietor, prior
16 to the formation of the corporation can be taken into
17 account. That concludes my opening statement, Your Honor.

18 THE COURT: Why do you take that position? Why
19 can't what he earned as the sole proprietor be considered
20 in what's reasonable?

21 MR. WHITE: Because, Your Honor, we take the
22 position that as a -- as a self-employed person, he cannot
23 meet the common law test of an employee. That he was, in
24 fact, an employer rather than an employee of himself. That
25 he couldn't be his own employee. We concede, Your Honor,

1 that services rendered as the sole proprietor can be used
2 in determining whether he meets the eligibility test in
3 terms of number of years, but not in determining benefits.

4 THE COURT: Is that because as an employee he
5 wouldn't be able to earn as much as he would if he were
6 self-employed? Because if he were an employee, the em-
7 ployer would -- would reap some of the rewards of his
8 efforts? Is that the idea?

9 MR. WHITE: I can't say for sure, Your Honor.

10 THE COURT: Let me ask you another question.
11 Why doesn't Section 482 apply in this case? The section
12 which allocates income and deductions between related tax-
13 payers or to other taxable periods?

14 MR. WHITE: Well, we believe, Your Honor, that
15 this case is a matter of a simple issue. Was the contribu-
16 tion plus the non-deferred wage payments excessive in
17 light of the services rendered, or weren't they? Consider-
18 ing what happened in that seven day period.

19 THE COURT: Yes, but in allocating the -- in the
20 statutory notice, didn't the respondent really allocate
21 this contribution to -- to the period covered by the con-
22 tribution, and thus reduce the deduction? Wasn't that how
23 you --

24 MR. WHITE: I think it could be argued that that
25 conclusion can be reached from the statutory notice, but

1 I believe that the explanation -- the narrative explanation
2 indicates that the compensation was excessive for the
3 services rendered during the period involved.

4 THE COURT: Well, if you don't want to rely on
5 482, I'm not going to decide the case on that basis. But,
6 don't raise it on brief.

7 MR. WHITE: I don't intend to argue 482, Your
8 Honor.

9 THE COURT: Well, very well. Don't let brief
10 review attempt to raise it for the first time on brief,
11 either, because I won't consider it. Would petitioners
12 like to -- Mr. Thies?

13 MR. THIES: Your Honor, could I be helpful --
14 and, I know this is colloquy and a little irregular on the
15 482 question, just to be helpful to you -- why it wasn't
16 properly raised by the government?

17 THE COURT: Sure.

18 MR. THIES: The pension area is a very intricate
19 one, and going back to the 1939 Code, and certainly to
20 regulations to that code under the Revenue Act of '42, in
21 the war, really, we had a big growth of pensions, and a lot
22 of people didn't know what they were doing. And, the
23 Revenue Service attempted to set out a lot of standards.
24 What is an appropriate way to fund a pension? The section
25 under the '39 Code was Section 23. That corresponds to 404

1 today. And, the Revenue Service -- the then Bureau, put
2 out a very extensive, long -- gee, it must be 50 pages --
3 memorandum on proper deductions under Section 23. At this
4 time, 482, or its predecessor in the '39 code -- I guess it
5 was there --

6 THE COURT: Forty-five.

7 MR. THIES: -- was very primitive, and was hardly
8 used, but the IRS had developed, and the ^{courts}~~cohort~~ and pension
9 administrators had developed such very extensive rules in
10 what is now the 404 area, for properly allocating a pension
11 contribution and pension costs to various time periods. So,
12 I suggest, Your Honor -- it's a very creative thought --
13 that basically it's because there is so much law in the 404
14 area that we haven't had to use. The Service, by its own
15 regulation, has, in effect -- has special 482 standards in
16 the 404 area that we don't have to go outside of it.

17 THE COURT: I'm not going to raise it if the
18 parties don't want to. You can call your first witness.

19 MR. THIES: Thank you. I'd like to call Angelo
20 J. Bianchi, D.D.S..

21 THE CLERK: Would you raise your right hand,
22 please? You do solemnly swear that the testimony you're
23 about to give the Court in this case shall be the truth,
24 the whole truth and nothing but the truth, so help you,
25 God?

THE WITNESS: I do.

1 THE CLERK: Be seated and state your name and
2 address for the record, please.

3 THE WITNESS: Angelo J. Bianchi, 1935 Clinton
4 Avenue, North, Rochester, New York.

5 MR. THIES: Doctor, would you be careful to
6 speak -- I notice there are two microphones. Mr. Copeland,
7 which is the one that's -- that he should be -- the small
8 one?

9 THE COURT: I think he has the right one now.

10 MR. THIES: Good. Fine, Doctor --

11 ANGELO J. BIANCHI,
12 called as a witness, having been duly sworn, took the
13 stand and testified as follows:

14 DIRECT EXAMINATION

15 BY MR. THIES:

16 Q Dr. Bianchi, would you please fully identify your
17 relationship to this case?

18 A I am one of two petitioners of this case, my wife,
19 Ida, being the other. And, I am the president, director
20 and sole proprietor -- sole stockholder of this corporation.

21 Q Have you read the Stipulation of Facts in this
22 matter, and are you familiar with the facts therein stip-
23 ulated?

24 A Yes, I am.

25 Q Are there any significant omissions therein as to

1 your education, experience, skill, earnings and the like,
2 you'd wish to bring to the attention of the Court?

3 A No, it's all in there.

4 Q Would you please describe the pension plan adopted
5 by your corporation -- no, just a moment, I -- if you'll
6 excuse me, Your Honor, let me get an exhibit that could
7 properly -- Dr. Bianchi, I show you an exhibit marked Joint
8 Exhibit 4-D. This is the Form 462. Do you want to see it,
9 Mr. White?

10 MR. WHITE: No.

11 MR. THIES: And I turn to Page 3 therein. The
12 employee census. Would you go across the columns -- they
13 may be self-explanatory, but it might be helpful -- this is
14 a very important part of the case -- starting with the
15 column on your far left there. What is the names down
16 there?

17 A Well, Bianchi, A., which would be myself, and
18 then Kravetz, S., which would be my dental hygienist. And
19 the next column is office -- officer or supervisor. I am
20 an officer is yes, and Miss Kravetz is no. A percent of
549 stock owned is 100% by myself. And the age is 50 for my-
21 self and 30 for my hygienist. Years of service is zero.
22 My base or regular rate is \$48,000.00 for myself
556 and \$7,540.00 for my hygienist. Total, the same figure.
24 The annual benefit expected is \$22,678.00, and for my
25

1 hygienist is \$2,262.00. Amount allocated for benefit under
2 employee is \$16,470.00, and \$523.00 for Miss Krametz.

3 Q And the other columns are all blank?

4 A Yes.

5 Q In Column F, does it -- would you read again the
6 top? Does it say basic or regular rate?

7 A Basic or regular rate. This is \$48,000.00, and
8 \$7,540.00.

9 Q That's not the actual compensation paid, but the
10 rate, apparently, on an annualized basis?

11 A Yes.

12 Q Thank you, Doctor. What was your understanding
13 of the level of benefits that this pension was supposed to
14 provide you?

15 A It was supposed to be 50% -- 30% of benefit plus
16 30% beyond basic compensation, like your Social Security.

17 Q I think you misspoke for the -- just to have
18 things accurate, what was the formula again?

19 A Fifty percent, plus 20%, I think. Thirty per-
20 cent, or -- I'm a little confused.

21 Q May I now lead the witness --

22 because -- it's almost stipulated anyway. The
23 pension benefit on the base was 30% of total compensation,
24 plus 20% --

25 A Plus twenty.

1 Q -- of amounts in excess of the Social Security
2 base, is that correct, Doctor?

3 A Yeah. Yes.

4 Q And, what was your understanding and intention,
5 on behalf of the corporation, as to the amount of the in-
6 tent -- of the initial full pension deposit?

7 A It was slightly under \$17,000.00.

8 Q How many participants were there in the plan?

9 A Just two. Myself and Miss Kravetz.

10 Q What was your understanding as to when the nearly
11 \$17,000.00 was required to be deposited?

12 A It had to be at the end of the corporate taxable
13 year.

14 Q And, in the next year if compensation had re-
15 mained the same, was a further deposit required?

16 A Yes, it was.

17 Q In what amount?

18 A It all depended on the amount of the --

19 Q If the compensation remained level, what amount
20 would be put in?

21 A The same amount.

22 Q And, if the compensation remained level to 65,
23 what amount would be put in each year thereafter?

24 A It would be the same amount each year if the
25 compensation's the same. That's --

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1 Q All right. I'm summing up here anyway, but
2 your understanding was, in this type plan, \$17,000.00 would
3 be put in each and every year by the end of the taxable
4 year --

5 A Yeah.

6 Q -- to age 65?

7 A Right.

8 Q Dr. Bianchi, what's the method of accounting that
9 was adopted by your corporation?

10 A Cash method.

11 Q And, in connection with the nearly \$17,000.00
12 pension contribution, where did the corporation get the
13 wherewithal to make that by the end of its first, short
14 year?

15 A Well, I loaned the corporation the money from
16 my personal account.

17 Q Can you recall, Doctor, approximately what amount
18 the loan was?

19 A Well, as I recall, approximately \$13,000.00.

20 Q Why did you adopt such a short initial fiscal year?

21 A Well, there were three reasons. One was the --
22 there's a substantial amount of life insurance incorporated
23 into the plan, and this was -- I had to do this promptly
24 for the protection of my family. Secondly, the quicker,
25 or more promptly we adopted this plan, the -- the income

1 generated from this contribution would be greater. And the
2 historical costs of the plan over a period of years would
3 be lower than if I delayed it.

4 Q Your Honor, I'm not sure whether this is tech-
5 nically correct, but I looked into my compound interest
6 books and I think it's a matter of which you could take
7 judicial notice that \$1.00 at 6% compounded annually will
8 grow to \$22.28 in 14 years, but will grow to \$24.67 in 15
9 years, which is over 10% more.

10 THE COURT: At what rate of interest?

11 MR. THIES: At 6% compounded annually. You don't
12 have compound interest tables with you -- I do.

13 THE COURT: No, and I don't know them offhand.

14 MR. THIES: Perhaps you'd like for me to ask
15 Mr. Cichanowicz, the pension consultant, on that. He
16 probably does have tables with him.

17 THE COURT: Well, it's agreeable -- the tables
18 are within the realm of judicial notice anyway, I'm sure.

19 MR. THIES: Okay. I'm sorry, Doctor, I interrupted
20 you. What was the third reason?

21 A Well, the third reason, at the time -- at this
22 time I was two months past --

23 Q When you say at this time, what are you talking
24 about?

25 A In November, 1970, I was two months past age 50,

1 and in order to require -- in order to meet the pension plan
2 requirements, I would have to have fifteen years of con-
3 tributions. Now, in order to get 15 years, to get full
4 benefit, I would have to have 15 years of contributions,
5 and this would make the cost of the plan lower, because I
6 would be contributing over a 15 payment period rather than
7 a 14 year period -- payment period, to get full benefit at
8 age 65.

9 Q Doctor, what are your career plans for the future?

10 A Well, I hope to be practicing dentistry just as
11 I am, at least until age 65, if my health permits, and
12 possibly retire at 65, with normal retirement age.

13 Q What are your best estimates of future earnings
14 for your professional corporation?

15 A Well, they should go up, and they have been
16 going up, and I see no reason why they shouldn't go up. I
17 have a continuing education course which I've continued
18 for over 25 years, and as I educate myself, I increase my
19 productivity, and with productivity and advances in tech-
20 nology, my income has got to go up.

21 Q How about your personal earnings as president of
22 the corporation?

23 A Hopefully they'll rise, too. They should rise
24 with the corporation.

25 Q If they do -- if the -- if your expectations are

1 borne out, if the corporation's income continues up, and
2 your own earnings personally, as president, keep pace with
3 it, what will this do to future pension contributions?

4 A They will increase. They will rise.

5 Q Doctor, in making the initial pension deposit,
6 and in claiming a net operating loss as a tax deduction,
7 did you rely on the advice of any experts?

8 A Yes, I did.

9 Q Who were they?

10 A My accountant, Mr. Sam Bianchi, Mr. Cichanowicz,
11 a C.L.U., and an attorney, Mr. Bob Tyle.

12 Q And, what did --

13 A And, they said this was all perfectly proper,
14 nothing wrong with it.

15 MR. WHITE: Your Honor, I'd like to move to strike
16 that last remark as not being responsive to the question.

17 MR. THIES: I think -- I quite agree. I concede
18 that. Doctor Bianchi, what did these gentlemen tell you?

19 A It was perfectly proper.

20 Q At the time of the incorporation, Doctor, what
21 were the assets set over to your P.C. in return for its
22 stock?

23 A All the physical -- all the physical equipment
24 that I have, accounts receivable, my name and my good will.

25 Q And, what did you receive back as consideration

1 for that?

2 A The stock certificate for the corporation.

3 Q What happened to your personal former patients?

4 A They're still my patients. The business continued
5 on as it has been.

6 Q And, what happened to the employees that you
7 formerly had as a solo practitioner?

8 A Well, one has subsequently left, and I have --

9 Q Well, I mean immediately after the incorporation --

10 A Oh, she continued on as she had been for over
11 two more years. Almost three years.

12 Q Your Honor, I have no further questions, unless
13 you would wish to address some from the bench.

14 THE COURT: I don't have any. Would you like to
15 cross examine, Mr. White?

16 CROSS EXAMINATION

17 BY MR. WHITE:

18 Q Dr. Bianchi, you mentioned that you relied on the
19 advice of an accountant, insurance man and your attorney.
20 When did you -- when were you first approached by the
21 insurance man?

22 A In regards to the pension plan?

23 Q Yes.

24 A Oh, maybe about two or three months previous.

25 Q You had mentioned that you had -- you were

1 continuing in an education course, is that correct?

2 A I said continuing education. Every year we have
3 seminar courses and Dental Society meetings, and I have
4 enrolled in short courses.

5 Q How would that affect your future earnings? The
6 fact that you were taking this -- these continuing educa-
7 tion courses?

8 A As you educate yourself, you increase your skills,
9 and as you increase your skills, your earnings should go up.

10 Q Are you saying that as you get more education,
11 you're going to raise your fees? Is that what you're saying?

12 A It might possibly be, but also increase your
13 productivity, too. Time and motion studies are very im-
14 portant.

15 Q Is there anyone who is a member of the corpora-
16 tion, Angelo J. Bianchi, P.C., who is qualified to do the
17 type of work that you do?

18 A Just myself.

19 Q You had mentioned that Mrs. Kravetz left. When
20 did she leave?

21 A Miss Kravetz.

22 Q Miss?

23 A Miss Kravetz.

24 Q Oh, I'm sorry, Miss Kravetz left.

25 A She had to leave because of illness.

40

1 Q I see. And, who -- did you have any other em-
2 ployees -- did the corporation have any other employees be-
3 sides yourself --

4 A At that --

5 Q -- and Miss Kravetz back in 1970?

6 A No.

7 Q At the time that you loaned the money to the
8 corporation to make the pension plan contribution, did you
9 give the corporation a note? I mean, did the corporation
10 give you a note to evidence that loan?

11 A Yes.

12 Q And, could you tell me when that loan was repaid?

13 A In 1970 sometime. I just can't -- I'm sorry,
14 1971, I think. I'm not -- I can't be sure the exact date.

15 Q Were your services that you rendered to the
16 corporation during the one week period, November 23, 1970
17 to November 30, 1970, any different than the services that
18 you rendered to the corporation, say, during the next fiscal
19 year, which would be the one ending November 30, 1971?

20 A No.

21 Q No further questions.

22 THE COURT: Questions on redirect?

23 MR. THIES: I don't have any questions on re-
24 direct, Your Honor.

25 THE COURT: I have some questions. Do you have

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1 the note in the Courtroom that was used to borrow this
2 money?

3 MR. THIES: I don't, Your Honor.

4 THE WITNESS: No, I don't.

5 THE COURT: Can you recall, did you charge the
6 corporation interest?

7 THE WITNESS: No.

8 THE COURT: What kind of note was it? Was it a
9 demand note, or did it have a fixed time for repayment?
10 Do you recall?

11 THE WITNESS: As I recall, a demand note. No
12 fixed time.

13 THE COURT: Demand note? Very well, I have no
14 further questions.

15 MR. THIES: You may step down, then, Dr. Bianchi.
16 Thank you.

17 (Witness excused)

18 MR. THIES: At this time I would like to call
19 Philip J. Cichanowicz, C.L.U..

20 THE CLERK: You do solemnly swear the testimony
21 you're about to give the Court in this case will be the
22 truth, the whole truth and nothing but the truth, so help
23 you, God?

24 THE WITNESS: I do.

25 THE CLERK: Be seated and state your name and

1 address for the record, please.

2 THE WITNESS: My name is Philip J. Cichanowicz,
3 11 Leonard Crescent, Penfield, New York.

4 PHILIP J. CICHANOWICZ,
5 called as a witness, having been duly sworn, took the
6 stand and testified as follows:

7 DIRECT EXAMINATION

8 BY MR. THIES:

9 Q Mr. Cichanowicz, will you please, for the Court,
10 describe your education background and training, particularly
11 as they relate to pensions, pension design and pension ad-
12 ministration.

13 A My formal education was received at the University
14 of Chicago, where I obtained my Doctor of Chiropody degree --
15 that's a foot doctor. However, that's not related here.
16 My first pension school which I attended was with the
17 Equitable Life Assurance Society, and that was in 1958.
18 Subsequent to that time, I took the Research and Review
19 Service of America pension course, '63-'64, which led to a
20 diploma in pension design and administration. Subsequent
21 to that time, I attended Security Mutual Life Insurance
22 Company of New York home office schools in pensions in 1966,
23 and in 1968. And, as part of the C.L.U., the Chartered
24 Life Underwriter training program, and a semester on
25 pensions and profit sharing plans in 1968. I took that

1 particular course and, of course, successfully completed it.
2 I obtained my C.L.U. designation in 1969, and subsequent to
3 that time, I've attended approximately two seminars per
4 year in pension and profit sharing, and qualified plans in
5 general, sponsored by the Institute of Business Planning,
6 the Research and Review Service of America and, of course,
7 the Society of Chartered Life Underwriters. I have appeared
8 as a panel speaker on qualified plans, including pensions,
9 profit sharing, put on by the Society of Chartered Life
10 Underwriters. And, currently I teach a class in pension
11 and profit sharing plans, design, administration and fund-
12 ing to the 21 agents in my agency of the Security Mutual
13 Life Insurance Company of New York in Rochester. And, I
14 established my first pension plan in 1961.

15 Q Would you please describe your role in the pension
16 plan in issue?

17 A I designed the plan in issue, I recommended it,
18 and it was adopted.

19 Q How did you go about this?

20 A When you say how did I go about it, what do you
21 mean?

22 Q How does one design and recommend a pension plan?

23 A I had several conferences with Dr. Bianchi. I
24 got some idea of his objectives in terms of retirement, in
25 terms of his family as it relates to estate benefits. I

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2 then procured a census which lists compensation, employees,
3 dates of birth, dates of employment, et cetera. [This data
4 was submitted to Security Mutual Life's home office. They
5 issued several computer print-outs as to various pension
6 possibilities. And, in subsequent discussions with Dr.
7 Bianchi, there was a particular plan, which is the one in
8 the stipulation that was adopted, and that's pretty much
9 the situation.

10 Q What pension contribution -- what amount of
11 pension contribution was called for by the plan you eventually
12 recommended and which was adopted by the corporation?

13 A It was approximately \$17,000.00.

14 Q And, in accordance with your understanding of the
15 plan you had designed and which was adopted by the corpora-
16 tion, at what time was the pension deposit required to be
17 made?

18 A The pension deposit was required to be made
19 when the corporation assumed the liability, which was upon
20 the signing of the trust, itself. That was signed on
21 November 24, 1970.

22 Q What form of funding was used in the plan?

23 A The funding method used in this plan was what
24 we call the individual level annual deposit method.

25 Q And, how does that method -- could you describe
it to the Court? How do you calculate it, and what do you

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1 do?

2 A Well, it's rather complicated, but essentially
3 what we do is to determine the amount of benefit which must
4 be payable to each individual at normal retirement date.

5 Q What was normal retirement date?

6 A In this plan it was age 65, or 10 years of service,
7 whichever came first. Now, once the benefit is determined,
8 we now must determine what capital sum of money is re-
9 quired to purchase this benefit. And, in this case, there
10 was a survivorship benefit built in, in terms of what we
11 call a ten year certain, so that added to the cost. Then
12 we look to see if there are life insurance cash values
13 which represent a part of the funding vehicle -- in this
14 case there were -- and we deduct the amount of cash value
15 from that capital sum required. We next make certain
16 assumptions. In this particular case we assumed that we
17 could earn, on monies deposited in a side fund, if you will,
18 5% compound interest. We assumed that there would be no
19 employee turnover, because of the smallness of the -- size
20 of the corporation participants. We assumed that there
21 would be no mortality, and on that basis there is a table
22 which now tells us how much is to be deposited on a level
23 annual premium basis to accumulate the amount of money re-
24 quired to fund the benefit at normal retirement date.
25 That was done in this case.

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1 Q Is this individual level deposit method a common
2 one?

3 A Yes, indeed.

4 Q About what percent would you say of definite
5 benefit plans for small employers use this method?

6 A I would say that 90%, or even higher, would use
7 this method, because it's the most commonly accepted funding
8 method, and the most sound.

9 Q Is this method acceptable to the IRS?

10 A Yes, indeed. As a matter of fact, under the old
11 2950 Forms, which are filed to substantiate the deduction,
12 it explicitly refers to this method, and then the subsequent
13 Form 44 -- 4848 in Schedule A also explicitly refers to
14 this method, and I haven't seen the new forms under
15 E.R.I.S.A., but I have to assume that they will also re-
16 cognize this method.

17 Q You heard my honored opponent argue that the
18 proper pension contribution should have been not the
19 \$16,933.41 claimed, but rather seven three hundred and
20 sixty-fifths thereof, representing the seven days in the
21 first fiscal year. As an expert on pensions, have you
22 ever heard of any such method or limitation?

23 A No.

24 Q In your opinion, as an expert on pensions and
25 pension administration, would such a small pro rata

1 contribution be proper, as a matter of good pension ad-
2 ministration?

3 A I see no way in which we could possibly calculate
4 the seven three hundred and sixty-fifths annual contribution
5 on a level basis.

6 Q Well, let me break in. You can calculate it by
7 multiplying by seven three sixty-fifths.

8 A No, no. No. What I'm saying is, in good pension
9 administration. First of all we have in this case in issue,
10 a life insurance policy, which is a substantial amount.
11 There is no life insurance company, to my knowledge, that
12 would accept a seven three hundred and sixty-fifth annual
13 premium. Number two, when you have, in this case, an
14 auxiliary funded pension program, there must be a relation-
15 ship between the auxiliary fund and the amount of insurance
16 involved. It must be incidental to the plan, meaning the
17 insurance death benefit must be incidental to the plan. So,
18 therefore, there must be a relationship when the premium
19 is contributed, also to the auxiliary fund contribution.
20 In this instance, as in practically every case, annual
21 premiums -- annual contributions to auxiliary funds are
22 most common, and there's no way that I know that we could
23 have done it on a seven three hundred and sixty-fifth
24 basis.

25 Q Can you imagine that any life insurance company

1 would have accepted a seven three hundred and sixty-fifths
2 funding?

3 A No. No way.

4 Q Mr. Cichanowicz, if an employee came into this
5 plan in the next year, towards the end of the plan year --
6 let's say the employee had one month of actual service to
7 November 30, 1971 -- under the plan, what sort of deposit
8 is required in relation to that employee's actual pay, or
9 annualized rate of pay?

10 A Again, we would have to determine by the pension
11 benefit formula the actual benefit to be received for that
12 individual. And, again, working backwards, as I've already
13 described, we would determine what the level annual deposit
14 would be. We would have the corporation pay a level annual
15 deposit for that employee.

16 Q I apologize. I didn't ask a very -- I think I
17 misled you. When an employee comes in and has one month
18 of actual service to the end of the year, do you make one-
19 twelfth of a normal annual level deposit, or do you make a
20 full annual level deposit?

21 A A full annual level deposit. Pensions are, by
22 their very nature, long-term investments, and we hardly
23 can reduce them down to more than an annual level approach.

24 Q And, in this type of pension, which is a definite
25 benefit pension -- a level of benefit pension -- is that

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1 the type of pension administration that is normally used
2 when an employee enters near the end of the year².

3 A Yes.

4 Q In what percentage of the cases would you say
5 that's the case?

6 A I can think of no exceptions.

7 Q In your experience?

8 A In my experience it is always that way.

9 Q You talked, at one point, about the auxiliary
10 fund, Mr. Cichanowicz. Can you describe the -- for the
11 Court's edification, the method of funding in this case in
12 respect to investments?

13 A The auxiliary funded plan, which is the prototype
14 plan that was adopted in this instance, represents its very
15 being on the premise that the trustee can invest the funds,
16 perhaps better than the life insurance company can, using
17 guarantees built into, let's say, a fully insured plan.
18 In this instance we assumed an interest rate on the side
19 fund at 5%, which at that time was realistic, and the trust
20 permits any and all types of investments that may be used
21 in the side fund.

22 Q You mentioned the prototype plan used in this
23 case. Are you familiar with that prototype plan?

24 A Well, I should be. This is the prototype plan
25 that is called the auxiliary funded corporate prototype

1 pension plan of Security Mutual Life, my company, of which
2 I'm a general agent.

3 Q And, approximately how many times has your
4 general agency used such prototype plans?

5 A Of this particular type, if I can refer to my
6 notes, we have, in our general agency, some 122 qualified
7 plans, and this particular type was used in 65 of those
8 cases.

9 Q Have you ever heard of the actuarial funding
10 method advocated by the government being used in all those
11 instances?

12 A The actuarial funded method? I don't understand
13 what you mean.

14 Q The -- you described the funding method as the
15 individual level annual deposit method, with a full de-
16 posit no matter when an employee came in, or perhaps the
17 coincidence of a short first fiscal year. My learned
18 adversary wants to reduce that, in this instance, to
19 seven three sixty-fifths. Have you ever heard of such a
20 method?

21 A No.

22 Q Now, Mr. Cichanowicz, there's been a lot of talk
23 about the proper first year pension deposit having been
24 \$16,993.41, but I think it was suggested that that was a
25 number that popped out of a computer, and we all know that's

1 only as good as the data you put in. Have you independently,
2 by hand, calculated the appropriate first year deposit?

3 A Yes.

4 Q What was the deposit?

5 A The deposit for the two participants involved in
6 this plan, on a level funded basis, using the same assumptions,
7 of course, as the computer did, was \$16,999.63. Slightly
8 more than the amount contributed and, in essence, I guess
9 we could say that that plan is slightly under-funded at
10 that point.

11 Q By what -- about how much?

12 A I don't know. I guess it's about \$6.00 -- \$7.00.

13 Q You talked about the split funded or auxiliary
14 funded plan. Is there any alternative type of funding
15 vehicle that might have been used instead of a split funded
16 plan?

17 A Yes. One that is used quite often, although per-
18 haps less popular in high interest yield times, is the
19 fully insured plan. The fully insured plan is essentially
20 where the insurance company issues a retirement income con-
21 tract which, by its very guarantees in the cash value
22 table, assures that the retirement benefit will be provided
23 under the terms of that contract. It's interesting if we
24 take a look at that particular program. A fully insured
25 plan for the two participants involved, and again using the

1 same assumptions, the same interest, no mortality, no turn-
2 over, et cetera, as in the computer illustration that was
3 adopted, the actual level annual premium for a fully in-
4 sured plan to achieve the same benefit level for both par-
5 ticipants would require \$18,810.98 of contribution annually.

6 Q And, if the fully insured type plan had been
7 adopted, when would the pension deposit be due?

8 A It would again be due upon the inception of the
9 plan.

10 Q Why is that?

11 A Well, for a number of reasons, one of which re-
12 presents itself in economy, ~~It~~ it is much more economical
13 for the corporation to pay an annual premium in advance
14 than it is pieces along the way whereby there is a sur-
15 charge for that. And, secondly, in good pension planning,
16 if the corporation cannot afford essentially to handle a
17 level annual premium contribution, they probably should
18 never have adopted the plan in the first place.

19 Q In a fully insured plan, does the IRS permit
20 the deduction of a full annual premium in the context of
21 a short first fiscal year?

22 A Yes.

23 MR. WHITE: Your Honor, I believe that calls for
24 a legal conclusion. He hasn't established his qualifica-
25 tions as a tax expert.

1 MR. THIES: I would think the Court will ul-
2 timately decide legal questions, and I would agree with
3 that. But, I'm asking him -- let me rephrase that. I
4 think that's a good suggestion. As one acquainted necessarily
5 with the policies of the IRS, in your experience has any
6 IRS objection, except in this case, been made to a payment
7 and deduction of the full annual premium at the inception
8 of the plan?

9 A No. As a matter of fact, on the old Form 2950
10 that was used here, there is no breakdown in terms of the
11 level annual premium method in terms of whether it was a
12 short year, a long year, or what have you.

13 Q You're suggesting that the forms -- the IRS forms
14 sanction the full deduction?

15 A Yes, to my knowledge. There is nothing there
16 that would refute that.

17 Q If, instead of using a short first fiscal year,
18 Dr. Bianchi's corporation had operated for some twelve
19 months before closing its fiscal year and had made a con-
20 tribution at that time -- a pension contribution -- under
21 the plan adopted, would total pension contributions to the
22 doctor's age 65 have been greater or smaller?

23 A They would be greater.

24 Q Would you explain why?

25 A Well, when you're dealing with a defined benefit

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1 program, we must purchase a defined benefit at a pre-determined
2 time. In this case, his age, 65. The more time that
3 elapses -- in other words, the closer he gets to age 65,
4 the less time there is to make the contributions on a level
5 annual basis and, of course, the big point is, the less
6 compound interest will be available to that account.

7 THE COURT: I don't follow that answer as it re-
8 lates to the taxable year -- the fiscal year. What
9 difference does it make what the fiscal year is as far as
10 his coverage under the plan? Doesn't the annual level
11 payment, or deposit, in this case, roughly \$16,000.00,
12 cover one year under the plan?

13 THE WITNESS: That is correct.

14 THE COURT: Well, then, what difference does it
15 make whether the fiscal year is -- you're half-way into
16 the fiscal year, you're two-thirds of the way or three-
17 fourths through the fiscal year? What does the fiscal
18 year of the corporation have to do with the coverage under
19 the plan?

20 THE WITNESS: In my opinion, it has nothing to
21 do with it. But, the question was asked, if the plan
22 were adopted in the following year.

23 THE COURT: Well, that has to do with the adoption
24 of the plan. In other words, your answer as to coverage
25 has to do with the adoption of the plan as the key date,

1 not the fiscal year of the corporation? Very well.

2 THE WITNESS: Further, if I might add, if the
3 corporation had adopted the plan, and they did on Novem-
4 ber 24, and then in some quirk, in some way we were able
5 to develop the seven hundred -- seven three hundred and
6 sixty-fifths fraction of the annual, and therefore it means
7 that the balance of the money would have to be put in some-
8 what subsequent to that date, we are still going to have a
9 situation that costs more, because of interest.

10 THE COURT: I see that.

11 THE WITNESS: Now, as a point of information, I
12 developed some figures that had Dr. Bianchi waited and put
13 his money in a year later, which means essentially he
14 would have 14 years to provide the same benefits -- in
15 other words, pre-retirement death benefits, the ten year
16 certain life income at age 65, would require a contribution,
17 just for him, on a level annual premium basis of
18 \$18,758.40 for 14 years. If we multiply that times 14 years,
19 it's \$262,617.00, and by adopting it with the full 15 years
20 to go, and putting his money in promptly to gain interest,
21 right from the first day, they required a contribution just
22 for him of \$16,469.88. That times 15 years totals
23 \$247,048.00, or a difference of a lesser requirement of
24 some \$15,000.00.

25 MR. THIES: With about how many qualified plans

1 of professional corporations in the Rochester area are you
2 familiar?

3 A Approximately 45.

4 Q How would you characterize the amount of the
5 benefits in the plan in issue here, when compared to those
6 plans?

7 A The amount of the benefits, I would say, are
8 quite average.

9 Q You know there is an ordinary and necessary
10 issue in this case. I brought it up in my opening state-
11 ment, so did my learned adversary. How would you character-
12 ize the pension plan actually adopted in this case to the
13 practice of the P.C.? How do you find it? It's a little
14 vague --

15 A Restate your question. I don't --

16 Q I'm going to ask you a yes or no question. Do
17 you find it to be ordinary and necessary, appropriate,
18 sound and a good business decision?

19 A Yes, indeed.

20 Q With your knowledge of pensions, and the pensions
21 of professional corporations and the doctor's practice,
22 were you in his shoes would you have adopted this same
23 pension program?

24 A Yes, indeed.

25 Q With those same pre-conditions, would you have

1 put in the funding when he caused his corporation to do so?

2 A Yes, indeed.

3 Q And, would you have adopted a short first fiscal
4 year in order to get 15 contributions rather than 14?

5 A Yes.

6 THE COURT: I don't see how this witness can
7 have any expertise in the adoption of a fiscal year. I
8 don't know what -- how his experience would have any bearing
9 on that question.

10 MR. THIES: You may be right, Your Honor. Let
11 me -- may I test him on it? In your experience with em-
12 ployers, particularly in new corporations, is there often
13 a question of what is the best fiscal year to select?

14 A Yes.

15 Q And, this has bearing on the pension economics?

16 A Very much.

17 Q And, have they turned to you on -- do they often
18 turn to you, or, you tell me -- how often do they turn to
19 you?

20 A Most pension plans and profit sharing plans are
21 adopted in the waning days of the fiscal year of any corp-
22 oration for good business judgment.

23 THE COURT: Why?

24 THE WITNESS: Well, basically to obtain a tax
25 deduction.

1 THE COURT: That's what I thought.

2 THE WITNESS: But that's sound business sense.

3 Now, we have been involved in numerous corporations that
4 were really an extension of the sole proprietorship, and
5 it's not uncommon for that particular corporation to elect
6 a shorter than -- what is short? Shorter than a calendar
7 year, or twelve months? I don't know what you call short.
8 But, less than that. And, it's adopted for a good sound
9 business reason. And, in my judgment, I don't feel that
10 any taxpayer is required to pay more taxes than essentially
11 he's required to pay.

12 MR. THIES: Well, thank you. That's kind of
13 settled law, but --

14 THE COURT: Well, now, what other good sound
15 business reason do you have, other than tax savings? That's
16 a vague term.

17 THE WITNESS: Well, in this problem of develop-
18 ing adequate funds for retirement, and I could get on a
19 soap-box for this one, but I won't. Most people have a
20 very difficult time in accumulating funds for adequate re-
21 tirement, and I think we all agree that the Social Security
22 wage base does a lot for most of us, but those people that
23 are in higher incomes are in some way discriminated against
24 by the level of Social Security retirement benefits. In
25 many cases, with the high income tax bite on the available

1 funds to invest personally, on the part of many people, and
2 the erosion through taxes on earnings on such funds, many
3 people find themselves in a position, at age 65, having had
4 a lot of money, but very little left to provide for their
5 later years. I think this is particularly true in the
6 medical and dental professions. Now, to me, that is the
7 real crux of what we're trying to accomplish in sound pension
8 planning; however, it is the tax deferrment, if you will,
9 that really serves as a vehicle to help a man accomplish
10 these objectives.

11 MR. THIES: As a general manner, Mr. Cichanowicz,
12 for any business, be it a drugstore or a filling station,
13 is there any business reason why a plan would not be adopted
14 in the beginning of a fiscal year as against the end?

15 A In terms of adoption, once again, I don't think
16 that any corporation, particularly the size that we're
17 talking about, which is the small, closely held corporation,
18 is familiar with what happens to their business or to their
19 practice or to their corporate profit and loss statement
20 until somewhere toward the end of the year.

21 THE COURT: Well, in this case it was adopted at
22 the beginning and at the end, really, wasn't it?

23 MR. THIES: That's correct.

24 THE COURT: A seven day period isn't a very long
25 fiscal year.

1 MR. THIES: Mr. Cichanowicz, you've read the
2 stipulation, have you not?

3 A Yes.

4 Q And, you're familiar with its facts?

5 A Yes.

6 Q And, you'll note that for the short fiscal year
7 that His Honor just referred to, Dr. Bianchi was actually
8 paid wages of some \$923.00. And, yet a full annual level
9 pension contribution of \$16,470.00 was put in, allocable
10 to his account. And, your opinion, as a expert on pension
11 administration, was this required by the terms of the plan?

12 A Yes.

13 Q Was it appropriate as a matter of sound pension
14 administration?

15 A Yes. I might add in all of the cases that we
16 have participated in, which are far beyond this 122, that
17 we have never illustrated a contribution to any defined
18 benefit plan, other than on an annual contribution basis.

19 Q You've heard my learned adversary refer to the
20 IRS position that a -- the coincidence of a pension con-
21 tribution within a particular taxable period -- that we
22 just look rigidly at that one taxable year -- we add that
23 to the regular compensation paid to the participant em-
24 ployee in determining reasonable compensation. I ask you,
25 as an expert on pension administration and funding, as that --

1 does a pension contribution necessarily relate to the year
2 in which it is made?

3 A When you say does it relate to the year in which
4 it's made -- on a level funded plan, there are only so many
5 years to go to the normal retirement date. There's no way
6 to put in an extra year, as such. In other words, in this
7 case there were 15 for Dr. Bianchi. Now, when those 15
8 years are made, they will be made on a level basis. The
9 sooner Dr. Bianchi got his contribution in, the sooner his
10 plan, because of the interest assumptions that were used.
11 I --

12 Q Okay. I didn't ask a very good question. This
13 plan didn't set up explicitly a past service liability?

14 A No.

15 Q But, in a definite benefit pension what are the
16 aspects that any pension contribution could be said to
17 economically take into account of the employee's service?

18 A Oh, I understand. In many pension plans, and I
19 guess perhaps in all we do take a look at it, that there is
20 what is considered an entry age normal approach. The
21 entry age normal approach is essentially stating and re-
22 cognizing past service. In other words, if the man -- even
23 though the pension plan is being adopted currently --
24 really has performed services for a number of years, and in
25 making the calculations for the funding on that basis, we

1 will go back and say that had the plan been adopted so that
2 he would have been eligible ten years ago, or whatever the
3 situation is, that we would have accrued recognition for
4 past service credits. This can be funded against, and it
5 often is. In this situation, because of the small number
6 of participants, it is not a sound approach.

7 Q But, would you say that whether it is explicitly
8 set up, that economically a part of the pension contribution is
9 attributable to past service normally?

10 A Yes.

11 MR. WHITE: Your Honor, I think that this line of
12 questioning is irrelevant to the issue that we have before
13 the Court today. That it has not been established that
14 this was based upon past services rendered, because it
15 could not be because the corporation just came into ex-
16 istence. And, therefore, what happened with respect to
17 other plans as to taking into account past service credits,
18 has no bearing on the issue in this case.

19 THE COURT: Mr. Thies?

20 MR. THIES: May I speak to that? We're actually
21 getting into a point of law here. We're all familiar with
22 the IRS position that upon the incorporation of a un-
23 incorporated business, the service of the former pro-
24 prietor or partner then commences. He doesn't have any
25 prior service as an employee. I think we're also aware,

1 and we're getting into the legal area -- I'll brief it for
2 you, I hope adequately, Your Honor -- that the IRS has
3 recently acquiesced in the result in Farley Funeral Homes,
4 in which prior service of the partners was taken into
5 account for a prior service requirement for eligibility in
6 the plan. My learned adversary says yes, it can be done
7 for that, but it can't be done for calculating benefits,
8 and necessarily when you calculate benefits, the contributions
9 are going to be a function. They're going to be related
10 to benefits.

11 THE COURT: Doesn't -- can't a plan take prior
12 service of another employer or self-employment into con-
13 sideration for vesting purposes? It can, can't it?

14 MR. THIES: That, Your Honor -- with all due --
15 I think that's in a state of flux. I think the --

16 THE COURT: I think they approved plans that did.

17 MR. THIES: I think the import of E.R.I.S.A. is
18 increasingly to require the employer to take into account
19 prior service for what's the same economic entity. I think
20 that's the trend to the law, and I think we're reluctantly
21 dragging the IRS into the 20th century, here. And, that's
22 why I think Mr. Cichanowicz's evidence -- testimony in
23 respect of the true economics of a pension is very much in
24 point.

25 THE COURT: I'll overrule the objection.

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1 MR. THIES: You heard the doctor testify that in
2 adopting the pension, making the amount of the pension con-
3 tribution and making it when he did, and adopting the fiscal
4 year that his corporation did, he, in part, relied on your
5 advice as a pension consultant. Do you -- is that testimony
6 correct?

7 A That is correct.

8 Q I have no further questions of the witness at
9 this time.

10 THE COURT: Mr. White, would you like to cross
11 examine?

12 CROSS EXAMINATION

13 BY MR. WHITE:

14 Q Mr. Cichanowicz, was it your testimony that --
15 that irrespective of what fiscal year was adopted by the
16 corporation, that the contribution to the plan would be
17 the same for a 12 month period?

18 A Yes. Assuming the facts were the same.

19 Q And, hypothetically speaking, assume that Dr.
20 Bianchi did not render any services to the corporation
21 during the seven day period, November 23 to November 30,
22 1970. Are you saying that the amount necessary for the
23 funding of the plan that would be required to be paid at
24 that time would be \$16,470.00 for Dr. Bianchi?

25 A If he rendered no services?

1 Q Right.

2 A In other words, he was not an employee?

3 Q He was an employee, but for some reason he didn't
4 render any services.

5 A And received no compensation?

6 Q Received no actual wages during that period.

7 A When -- when we develop a contribution --

8 Q Give me a yes or no answer, please.

9 A It's a very difficult question to answer yes or
10 no. May I elaborate?

11 THE COURT: Can't you answer it?

12 THE WITNESS: Well, a man is either an employee
13 or an employer, or he isn't. If he were not an employee
14 in your instance, there could be no contribution.

15 THE COURT: There are employees that don't per-
16 form services. Suppose he was ill. Would the contribution
17 still have to be made?

18 THE WITNESS: We're talking about at the time of
19 adoption?

20 MR. WHITE: We're talking about during the period
21 November 23 through November 30, 1970, and based upon your
22 prior testimony that the plan was adopted on November 24,
23 1970. Now, assuming that Dr. Bianchi rendered no services
24 between November 24th and November 30th, would the cor-
25 poration still have been required to make a contribution of

1 \$16,470.00 to fund the plan?

2 A No, he would not have been an employee under
3 the terms of the plan, itself, as described here.

4 Q I said, assuming that he was an employee.

5 A Well, under the definition of eligibility, we
6 have to get involved in the number of hours an employee
7 works. Now, to render services, to me requires hours of
8 work.

9 Q Well, okay, let me ask you, making one more
10 further assumption, and assuming that he rendered the re-
11 quisite number of hours during the period from November 30th,
12 1970 through November 30th, 1971, would you have -- would
13 the corporation have had to pay \$16,470.00 before Novem-
14 ber 30th, 1970? In other words, assuming that he rendered
15 services during the first calendar year that met the
16 eligibility requirements, but none of those services were
17 rendered during this seven day period. Would you still have
18 had to have the corporation make a contribution of
19 \$16,470.00 in his behalf?

20 A Sure.

21 Q No further questions.

22 THE COURT: Any redirect?

23 MR. THIES: I have nothing on redirect, Your
24 Honor.

25 THE COURT: You're excused as a witness.

(Witness excused)

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1 THE COURT: Would you like to call your next
2 witness?

3 MR. THIES: At this time I would like to call
4 Dr. Peter A. Carillo.

5 THE CLERK: Would you raise your right hand,
6 please? You do solemnly swear that the testimony you're
7 about to give the Court in this case will be the truth,
8 the whole truth and nothing but the truth, so help you,
9 God?

10 THE WITNESS: I do.

11 THE CLERK: Be seated and state your name and
12 address for the record, please.

13 MR. WHITE: Your Honor, before Mr. Thies starts
14 his line of questioning, we would like to object to the
15 testimony of this witness on the basis that what compensation
16 is paid, or what earnings are received by other doctors in
17 the Rochester area are irrelevant insofar as what the value
18 of the services were of Dr. Bianchi to this corporation,
19 because I don't think you can equate a sole proprietorship
20 business consisting of one dentist, with a "1120 S" cor-
21 poration where the dentist is merely an employee. I don't
22 think you can equate the two situations.

23 MR. THIES: Your Honor, that's really a variant
24 on the argument that Mr. White previously made when it
25 got in -- that the service, prior to incorporation, may

1 not be taken into account in determining a proper and
2 appropriate pension plan and design. We believe that the
3 trend of the cases and the acquiescence in Farley Funeral
4 Homes, Inc., and the suggestions in E.R.I.S.A. indicate
5 that you should look at this on a long-term basis. That in
6 an incorporation, it's basically the same economic unit
7 continuing in another form, and it would be highly formal-
8 istic and unrealistic not to take into account the his-
9 torical compensation of the person who was really producing
10 the earnings.

11 THE COURT: Well, doesn't respondent take the
12 position in this case that this compensation was not
13 reasonable?

14 MR. WHITE: Yes, we do, Your Honor.

15 THE COURT: Well, how would you propose for
16 petitioner to prove the compensation was reasonable? If
17 that's your contention, you've got to give him some way to
18 prove it. How would he prove it?

19 MR. WHITE: Well, I believe, Your Honor, that
20 he would have to offer testimony establishing what other
21 P.C. corporations, having one employee who did the par-
22 ticular work involved, earned. But, not doctors who are
23 sole practitioners or sole proprietors filing a Schedule C
24 business. To the extent that the testimony is going to
25 relate to what dentists are paid by their P.C. corporation,

1 I think it would be relevant. But not equating Schedule C
2 operations with what they would earn had they been an em-
3 ployee of a P.C. corporation.

4 THE COURT: Does it have to be a Sub-chapter S
5 corporation or not?

6 MR. WHITE: No, it does not. Or, a regular
7 corporation, Your Honor.

8 THE COURT: Well, I think you're getting to the
9 heart of the reasons that your argument doesn't make any
10 sense. If it's a Sub-chapter S corporation, the income is
11 all going to be taxable to the shareholder anyway. If it
12 isn't, it isn't. It's probably a personal holding company
13 then. I'll overrule the objection and permit the witness
14 to testify.

15 MR. THIES: Thank you.

16 PETER A. CARILLO,
17 called as a witness, having been duly sworn, took the
18 stand and testified as follows:

19 DIRECT EXAMINATION

20 BY MR. THIES:

21 Q Would you, Dr. Carillo, please state your name
22 and address for the record, please?

23 A My name is Peter A. Carillo, 4400 St. Paul Boule-
24 vard, Rochester, New York.

25 Q Dr. Carillo, will you please tell the Court your

1 educational background, special studies, professional
2 accomplishments and the like? E

3 A I'm a graduate of the University of Rochester,
4 and the University of Buffalo Dental School. I'm a member
5 of the Monroe County Dental Society, the Seventh District,
6 and the A.D.A., the American Prosthodontic Society, the
7 American Equilibration Society, the Academy of General
8 Dentistry --

9 Q Excuse me, you're going too fast.

10 A -- and a few others.

11 Q Please -- thank you. Would you go back to the
12 American Prosthodontic (sic) Society?

13 A Prosthodontic Society.

14 Q Prosthodontic Society?

15 A The American Equilibration Society, the Academy
16 of General Dentistry, and I am general consultant for St.
17 Anne's and Rochester General Hospital.

18 Q For how long, Doctor, have you been active in
19 the Monroe County Dental Society?

20 A Twenty years.

21 Q About how many members has such society?

22 A Three hundred and ninety-two.

23 Q And about approximately what percent of the
24 dentists in your area are members?

25 A Oh, 98% -- almost 99%.

1 Q What offices have you held in the Monroe County
2 Dental Society?

3 A Board of Director and Chairman of several of the
4 committees, and then up the chairs. Business Chairman,
5 Vice-President, President-elect, and now I am President.

6 Q Where exactly is Monroe County in -- geographically --
7 roughly?

8 A In Buffalo, they know.

9 Q Well, the Judge, you know, travels circuit. He
10 may not.

11 A It's 70 miles east of Buffalo, on the lake.

12 Q And, what does it -- is it fair to describe it
13 as including Rochester and the environs? It's a large
14 metropolitan area?

15 A That's about it. Maybe 400,000 people.

16 Q Okay. Is there an aspect of the Monroe County
17 Dental Society's work which has particularly interested you
18 of late years?

19 A I think mostly the dental economy. And how
20 dentists are going to cope with all this, and --

21 Q Have you --

22 A -- the rest.

23 Q Have you particularly studied dental economics?

24 A In our journals and in our seminars, and with my
25 position in the Society, talking with all of the members.

1 Q Would you characterize yourself as very knowledge-
2 able as to the economics of the profession in the Rochester
3 area?

4 A I would say so.

5 Q Well, Doctor, have you read the Stipulation of
6 Facts in this case, and do you understand the data set down?

7 A Yes.

8 Q And, by the way, if you don't -- if you want to
9 refer to it, ask me to show it to you. Did you hear and
10 pay attention to the testimony of Dr. Bianchi and Mr.
11 Cichanowicz on the stand?

12 A Yes.

13 Q Based on such evidence of the two witnesses that
14 preceded you, and of the stip -- stipulation, which is hard
15 evidence, and your knowledge of the economics of the pro-
16 fession, how would you characterize Dr. Bianchi's earnings
17 since 1964 through 1974 in the context of his training,
18 education and skill? His historical earnings.

19 A Actually, I was surprised because I thought it
20 was kind of low. Because Dr. Bianchi has an awful lot of
21 training that some men don't have.

22 Q Now, you'll notice that we broke out the pension
23 contributions allocable to his account for the years 1970
24 and '74. If -- and we don't concede it should be done --
25 but, if you assume for a moment that you should add these

1 pension contributions to his direct earnings, his salary
2 from the corporation for those years in issue, 1970 through
3 and inclusive of '74, would your prior answer be changed?

4 A No, I think he still would be definitely under-
5 compensated.

6 Q And, now I'm going to go back to a shorter period.
7 Going back, and it's the only matter immediately in issue --
8 going back to all facts through December 31, 1970, and
9 adding to his compensation that was set out from 1964, and
10 even if you add the nearly \$17,000.00 pension contribution
11 in dispute to that, as of December 31, 1970, would your
12 answer be the same? Through such period was he over, under --

13 A Yes, I think so. Yes -- I think so.

14 Q How would you characterize it? His compensation
15 on a historical basis?

16 A I'd say less than average.

17 Q Are you familiar with the pensions of incorporated
18 dental practices in the Rochester area?

19 A Yes.

20 Q You've heard the pension described, you've seen
21 the stip -- did you take a look at the 4462?

22 A Yes.

23 Q Okay. How would you characterize the pension
24 in issue here, and as the amount of the benefits projected,
25 to the average of the pensions with which you're familiar --

1 those of incorporated practices in the Rochester area --
2 in size of benefit?

3 A I'd say less than average.

4 Q In your opinion, as a student of this dental
5 economics, was the pension adopted appropriate to this sort
6 of a dental corporation? Let me break in. If mentally I
7 could pick you up and put you into Dr. Bianchi's skin, back
8 in November of 1970, as a good businessman -- you're a
9 practitioner of the healing arts, but you're also a business-
10 man -- as a sound business matter, would you have adopted
11 the pension he adopted?

12 A No question about it.

13 Q And made the contribution that he made?

14 A Certainly.

15 Q You've heard Dr. Bianchi testify that he feels
16 his corporation's earnings, his salary, and necessarily
17 related pension deposits will continue to go up. As a
18 student of dental economics, do you concur in that view?

19 A I have every confidence that will be the case.

20 Q I have no further questions of this witness.

21 THE COURT: It will be necessary to take a short
22 recess to change the tape on the recording equipment.

23 THE CLERK: Rise, please.

24 (Recess)

25 THE CLERK: Court is now in session. Be seated.

1 THE COURT: Mr. White, would you like to cross
2 examine?

3 MR. WHITE: Yes, Your Honor.

4 CROSS EXAMINATION

5 BY MR. WHITE:

6 Q Isn't it a fact that each dentist determines
7 what he is going to charge for fees? That there's no set
8 fee schedule set by the medical -- the dental practice --
9 or, the dental --

10 A In general. In general that's true. There is
11 a range, there's a profile.

12 Q But, each dentist is free to set his own fees,
13 is that correct?

14 A Yes, but it's within a range.

15 Q But, he is not bound by that?

16 A No.

17 Q No further questions.

18 THE COURT: Any questions on redirect?

19 MR. THIES: I'm baffled. I have none.

20 THE COURT: Thank you, Dr. Carillo. You're ex-
21 cused.

22 THE WITNESS: Thank you very much, sir.

23 (Witness excused)

24 MR. WHITE: Your Honor, the government has no
25 witnesses, so I believe that concludes the record in this

1 case.

2 THE COURT: Petitioners don't intend to call any
3 other witnesses?

4 MR. THIES: No, I don't, Your Honor.

5 THE COURT: Very well, the case is submitted.

6 MR. THIES: Your Honor, I made an indication,
7 however, that I would ask that briefs in this case be sub-
8 mitted -- that Your Honor direct that they be submitted
9 seriatim rather than simultaneously. Are you agreeable to
10 that, Mr. White? I think that's more logical.

11 MR. WHITE: Your Honor, in this type of case
12 we would request that there be original simultaneous briefs,
13 and then reply simultaneous, rather than seriatim.

14 THE COURT: I don't normally order seriatim
15 briefs. In fact, I think I've done it in one case since
16 I've been on the bench. I'll order simultaneous briefs,
17 opening briefs in 45 days and reply briefs 30 days there-
18 after. The Clerk will give you the brief due dates.

19 THE CLERK: Opening brief will be due November 21,
20 1975. And reply briefs will be due December 22, 1975.

21 THE COURT: Very well, the Court will recess un-
22 til one-thirty, at which time it will take up the Gary case.

23 (Whereupon at 11:00 A.M. the case was adjourned as
24 described above).
25

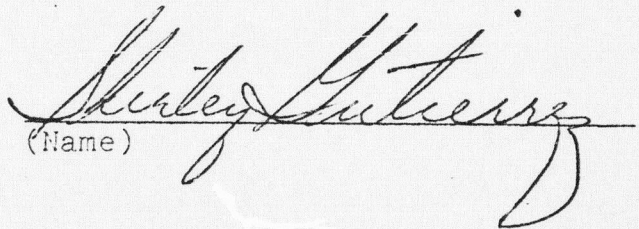
UNITED STATES TAX COURT

Certificate of Transcriber

Docket No. 8152-74

Name: Angelo J. & Ida J. Bianchi

The foregoing pages, numbers 1 through 57
inclusive, are the true, accurate and complete transcript
prepared from the verbal recording made by electronic recording
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in the United States Tax Court located in Buffalo,
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(Name)

10/21 & 10/22/75

(Date)

66 T. C. No. 35

UNITED STATES TAX COURT

ANGELO J. and IDA A. BIANCHI, Petitioners v. COMMISSIONER
OF INTERNAL REVENUE, Respondent

Docket No. 8152-74.

Filed May 20, 1976.

Petitioner-husband organized a corporation for his dental practice, which elected subchapter S status. The corporation elected a first taxable year of 7 days during which it adopted a pension plan covering petitioner-husband and his dental assistant. The corporation made its initial contribution to the plan covering the ensuing 12 months on the last day of its first (7-day) taxable year from funds lent to the corporation by petitioner secured by a demand, non-interest bearing note. The deduction produced a net operating loss for the corporation which petitioners deducted on their return. *Held*, the contribution, together with compensation paid to petitioner during its first (7-day) taxable year was unreasonable and properly disallowed in part by the Commissioner.

Petitioners conceded imposition of the negligence penalty (Sec. 6653(a), I.R.C. 1954) with respect to other adjustments made by the Commissioner in the statutory notice which they also conceded but they contest imposition of the penalty as to the contested adjustment. *Held*, the negligence penalty applies to the difference between the tax liability redetermined and the tax reported on petitioner's return.

Winthrop Drake Thies, for the petitioners.

John E. White and Kenneth Bersani, for the respondent.

GOFFE, Judge: The Commissioner determined a deficiency in petitioners' 1970 Federal income tax in the amount of \$9,554.75 and addition to tax for the negligence penalty (section 6653(a), Internal Revenue Code of 1954) in the amount of \$477.74. "Petitioner" shall hereinafter refer to Petitioner Angelo J. Bianchi. The issues for decision are:

(1) Whether petitioner's wholly owned subchapter S corporation, on its initial income tax return for its first taxable year of 7 days, may deduct the full amount of its initial contribution to its pension plan providing pension plan benefit coverage to petitioner and one employee for the ensuing 12 months;

(2) Whether petitioners are liable for the 5 percent addition to tax for negligence under section 6653(a).¹

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts and attached exhibits are incorporated by this reference.

¹All section references are to the Internal Revenue Code of 1954, as amended.

Petitioners Angelo J. and Ida A. Bianchi resided in Rochester, New York, when they filed their petition. They filed their joint Federal income tax return for the taxable year 1970 with the Andover Service Center, Andover, Massachusetts.

On November 23, 1970, petitioner organized Angelo J. Bianchi, P.C., hereinafter referred to as the corporation, a professional service corporation pursuant to the provisions of Article 15 of the New York Business Corporation Law (McKinney Supp. 1975). Its assets, upon incorporation, consisted of equipment previously used by petitioner in his dental practice as an individual proprietor, accounts receivable and good will. All of the stock of the corporation is now owned and has always been owned by petitioner. The corporation has at all times maintained its books and records and filed its Federal income tax returns on the cash basis of accounting.

Petitioner was born on September 17, 1920. He graduated from the Dental College of the University of Buffalo in 1949 and thereafter served an internship at the Eastman Dental Center, Rochester, New York, until 1950. After one year in private practice, he enrolled in St. Mary's Hospital, Rochester, New York, for a full-time, one-year course in general anesthesia. Following that,

he worked at Mt. Morris Tuberculosis Hospital, Mt. Morris, New York, for a period of 17 years administering general anesthesia for all types of surgical procedures while at the same time maintaining his dental practice.

For about the past 25 years, Dr. Bianchi participated in the programs of continuing education of the Rochester Dental Society. In addition, he has attended the annual University of Buffalo Dental Seminars since their inception some 15 to 20 years ago. Prior to 1970, he took crown and bridge courses and a course in implantology at the Institute of Graduate Dentists in New York City, New York. Petitioner's practice and his services to the corporation were and are a practice of general dentistry with heavy emphasis on crown and bridge work. The only phase of general dentistry in which he has done little work is in the field of orthodontia.

On November 24, 1970, petitioner, as president of the corporation, executed an Employees' Pension Trust Agreement. Pursuant to said agreement, a trust account (No. 05-05943-1) was opened on November 27, 1970, at the Bankers Trust Co., Rochester, New York. The pension plan and trust agreement of the corporation are adoptions of a Master or Prototype Pension or Annuity Plan (Serial No. 1701843) submitted to the Internal Revenue Service by

Security Mutual Life Insurance Co. of New York, 80 Exchange Street, Binghamton, New York 13902, and approved on April 22, 1970.

On November 30, 1970, the pension plan became effective. The plan provided that all employees between the ages of 25 and 56 years were covered; there was no requirement of prior service with the employer in order to establish eligibility under the plan. The corporation agreed to pay the full cost of the plan and to fund it by level annual payments to a trust established under the plan. This method of funding, based on individual level annual payments (also known as split funding) is designed to accumulate, with interest, the amount of money necessary to purchase an annuity which will pay a pre-determined benefit at retirement age over the estimated period of retirement. The retirement benefits under the plan were to be 30 percent of the participant's total compensation, based on the average of the five highest consecutive years of compensation, plus 20 percent of the participant's total compensation in excess of the amount provided as old age and survivor benefits under the Social Security Act. The normal retirement age was to be 65 years of age, provided the covered individual had participated in the plan for 10 years. Upon death,

the plan would pay an amount equal to 70 times the normal retirement benefit. The following pension contributions were to be made in behalf of the corporation's two employees to secure the annual expected benefit:

<u>Employee</u>	<u>Annual Compensation</u>	<u>Expected Annual Benefit</u>	<u>Allocable Pension Plan Contribution</u>
A. Bianchi	\$48,000	\$22,078	\$16,470
S. Kravetz	7,540	2,262	523

On November 27, 1970, the corporation elected to be taxed under subchapter S of the Code as a small business corporation.

Some time between November 23 and November 30, 1970, petitioner lent the corporation \$14,499.57 from his personal bank account in exchange for a demand note, without interest. This money was used by the corporation to make its initial pension plan payment in 1970. This debt of the corporation to petitioner remained unpaid as of November 30, 1970. On November 30, 1970, the corporation deposited the sum of \$16,993.41 in the trust account at Bankers Trust Co. for the pension plan contribution.

On February 18, 1971, the corporation filed its initial income tax return (Form 1120-S, U.S. Small Business Corporation Income Tax Return) for the taxable year November 23, 1970 to November 30, 1970, with the Andover Service Center of the Internal Revenue Service. On this return, the corporation deducted the full amount of the

initial pension plan contribution, \$16,993.41. Gross receipts for this period were \$1,340 and deductions, including pension plan contribution, were \$18,286.11, resulting in a net operating loss of \$16,946.11 for the first short taxable year. The corporation submitted a Form 2950 (Statement in Support of Deduction) relative to the pension plan contribution of \$16,993.41 claimed as a deduction on the Form 1120-S for the short taxable year November 23 to November 30, 1970.

The contributions of the corporation to the pension plan allocable to petitioner and claimed as deductions on its corporate Federal income tax returns for its taxable years ending 1970 through 1974 were as follows:

<u>Taxable Year</u> <u>Ended Nov. 30</u>	<u>Amount of Contribution</u> <u>Allocable to Dr. Bianchi</u>
1970 . . . . .	.\$16,469.88
1971	17,023.82
1972	16,003.16
1973	16,900.24
1974	21,931.85

The corporation's taxable income, or loss, reported on its corporate Federal income tax returns for its taxable years ending in 1970 through 1974 was as follows:

<u>Taxable Year</u> <u>Ended Nov. 30</u>	<u>Taxable</u> <u>Income (Loss)</u>
1970	\$(16,946.11)
1971	16,113.93
1972	13,027.89
1973	8,707.05
1974	3,915.97

On March 16, 1971, the corporation filed with the District Director of Internal Revenue, Buffalo, New York, an Application for Determination (Form 4462) covering its pension plan adopted in November 1970. The form was dated March 4, 1971, and set forth with particularity the aforementioned provisions of the pension plan. On April 20, 1971, the District Director informed the corporation by form letter that the plan qualified under either section 401 or section 405 of the Internal Revenue Code of 1954.

On their 1970 joint Federal income tax return, petitioners claimed a deduction of \$16,946.11 as petitioner's share (all) of the net operating loss of the corporation for its initial short taxable year. On Schedule C of petitioners' Federal income tax returns for the taxable years 1964 through 1970, petitioner reported the following net profit from his dentistry practice:

<u>Year</u>	<u>Net Profit From Profession</u>
1964	\$47,620.00
1965	38,039.00
1966	53,246.00
1967	62,450.00
1968	72,735.00
1969	75,702.00
1970	65,570.31*

*This amount is for the period January 1, 1970 through November 23, 1970, and was adjusted to \$81,473 in the statutory notice. Petitioner has agreed to such adjustment.

His wages from the corporation for its first short taxable year November 23, 1970 to November 30, 1970, were \$923.08 and his wages from the corporation for the month of December 1970 were \$3,692.32. The services performed for the corporation in the first short taxable year were no different from those he performed in any comparable period in 1971.

In subsequent taxable years, petitioner's wages from the corporation were as follows:

<u>Year</u>	<u>Wages</u>
1971	\$48,000.16
1972	48,223.24
1973	48,000.16
1974	48,000.16

The Commissioner, in his statutory notice of deficiency, disallowed the \$16,946.11 net operating loss deduction claimed by petitioner and determined that:

* * * the allowable deduction of such corporation for a contribution paid by an employer to or under its pension plan during its taxable year ended November 30, 1970, is \$325.89 (as computed below) since such amount, together with other deductions allowed for compensation for employees covered by the plan, constitutes a reasonable allowance for compensation for services actually rendered. Accordingly, it is determined that the net operating loss of Angelo J. Bianchi, P.C. for the taxable year ended November 30, 1970, is \$278.59 and that you are entitled to a net operating loss deduction of \$278.59 rather than \$16,946.11 as claimed on your return.

Computation of allowable deduction of Angelo J. Bianchi, P.C. for contribution to its pension plan.
 $7/365 \times \$16,993.4 = \$325.89.$

The Commissioner, in the same statutory notice of deficiency, adjusted other items on petitioners' return for 1970. Petitioners agreed to such adjustments and also to imposition of the negligence penalty (sec. 6653(a)) and paid the deficiency in tax and penalty.

OPINION

Section 404(a) of the Code provides that if contributions are paid by an employer to or under a pension plan, such contributions "shall not be deductible under section 162 (relating to trade or business expenses)" or section 212, but, if such contributions "satisfy the conditions of either of such sections, they shall be deductible" under section 404(a) subject to certain limitations not presently in issue. Petitioner asserts that the statutory reference to "section 162" encompasses only the ordinary and necessary requisites to which all trade or business expenses are subjected. Respondent maintains that both deferred and non-deferred compensation must be subject to the reasonable allowance standards set forth in section 162(a)(1).² Sec. 1.404(a)-1(b), Income Tax Regs.

² SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) IN GENERAL.--There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred

continued

Petitioners contend that if Congress intended section 404(a) to be subject to reasonable compensation standards, it would have specifically mentioned section 162(a)(1). They contend, therefore, that section 404(a) should only be subject to the ordinary and necessary standards of section 162(a). However, the very point for which they argue is subject to the same frailties upon which they urge rejection of respondent's position: section 404(a) subjects contributions to the conditions of section 162 without mention of either section 162(a) or section 162(a)(1). We conclude that because only a general reference to section 162 was made by Congress, it must have intended to incorporate all of the conditions of section 162.

Petitioners rely on Commissioner v. R. J. Reynolds Tobacco Co., 260 F.2d 9 (4th Cir. 1958), affg. T.C. Memo 1956-161, to support their contention that the amount of the contribution is to be examined only as to being

Footnote 2 - continued.

during the taxable year in carrying on any trade or business, including--

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

* * *

ordinary and necessary for the entire contribution and not as to reasonableness on an employee-by-employee basis.

In Commissioner v. R. J. Reynolds Tobacco Co., supra, it is unclear as to whether the bonuses paid to the employees in proportion to their shareholdings were additional compensation for the taxable year of payment or whether such payments related to services rendered in prior years. However, as stated by the Court of Appeals--

The Tax Court pointed out that in determining reasonableness, the individual salaries must be considered and not the overall reasonableness of the taxpayer's wage bill. * * * [260 F. 2d at 13.]

We agree with the recent statement in Edwin's, Inc. v. United States, 501 F. 2d 675, 679 (7th Cir. 1974), affirming in part and reversing and remanding in part 355 F. Supp. 773 (W.D. Wisc. 1972):

* * * pension payments constitute compensation which must be considered in determining whether the total compensation paid to an employee is reasonable.³ * * *

Petitioner has the burden of showing that the 1970 payment of \$16,667.52 disallowed by respondent was reasonable compensation. Botany Worsted Mills v. United States, 278 U.S. 282 (1929). The issue is factual. Respondent contends that we are precluded from examining petitioner's self-employment earnings from his dentistry practice because petitioner was not an "employee" as that

³Leonard J. Ruck, Inc., T.C. Memo 1969-16.

word is used in section 404(a). He asserts that the Treasury Regulations, section 1.404(a)-1(b), provide that only the past services of an employee are to be considered in determining the reasonableness of a pension plan contribution. He adds that pursuant to section 1.401-10(b)(3)(i)--

The term "employee", for purposes of section 401, does not include a self-employed individual when the term "common-law" employee is used or when the context otherwise requires that the term "employee" does not include a self-employed individual. * * *

Rev. Rul. 69-421, 1969-2 C.B. 59, Part 2(j)(1), sets forth respondent's position rejecting the prior service of self-employed individuals -- partners and sole proprietors -- for both prior service benefits and eligibility requirements. He, therefore, concludes that the prior services of a sole proprietor cannot be considered in determining the reasonableness of compensation, relying on Rev. Rul. 71-502, 1971-2 C.B. 199; Rev. Rul. 69-421, 1969-2 C.B. 59; Rev. Rul. 69-144, 1969-1 C.B. 115 and Rev. Rul. 69-36, 1969-1 C.B. 128. He supports his conclusion with what he views as two practical reasons. First, if the corporation were allowed to take petitioner's prior services as a sole proprietor into account, it would be allowed a deduction for an expense against income reported by petitioner rather than against income produced by the corporation. Such a circumstance, argues respondent,

would violate the general principle of allowing deductions only to the taxable entity which generated income relating to such deductions. U.S. Asiatic Co., 30 T.C. 1373 (1958); Underwriters Laboratories, Inc., 46 B.T.A. 464 (1942). Second, he assumes that to consider petitioner's prior services would result in the avoidance of the additional deduction limitations which are imposed by section 404(e) in the case of pension plans benefiting self-employed individuals. Specifically, for the year in question, section 404(e) limited the deduction for self-employed individuals to the lesser of \$2,500 or 10 percent of earned income. There was, of course, no such limitation with respect to corporations.⁴

Petitioner contends that respondent's position set forth in Rev. Rul. 69-421, that the prior service of self-employed individuals cannot be considered for the purpose of computing benefit and eligibility requirements of a plan, has been substantially undermined by three decisions. Farley Funeral Home, Inc., 62 T.C. 150 (1974); Sherman Construction Corp. v. United States, 358 F. Supp. 446 (E.D. Va. 1973); United States v. Kintner, 216 F.2d 418 (9th Cir. 1954). Each of the above decisions has indeed eroded

⁴It should be noted that had the corporation adopted a fiscal year ending after December 31, 1970, section 1379(b) of the Code would require petitioner to report as income the amount of the contribution in excess of \$2,500.

respondent's position of inapplicability of prior service of a self-employed individual for purposes of determining eligibility. Our question here, however, concerns whether the prior service of a self-employed individual should be considered when deciding what amount of contributions to the plan are within the confines of reasonable compensation.

Reasonable compensation is not limited to amounts paid as compensation for services actually rendered in the taxable year of payment. Compensatory payments made by an employer to an employee for past services may be deductible if reasonable without violating the integrity of annual accounting concepts. Lucas v. Ox Fibre Brush Co., 281 U.S. 115 (1930); R. J. Nicoll Co., 59 T.C. 37, 50 (1972). However, in the case before us we are concerned with a current corporate employer which is a taxable entity different from the one which generated petitioner's past compensation. We are faced with two questions: (1) whether it is proper to examine prior earnings from self-employment to decide if current compensation, both direct and deferred, by a corporate employer is reasonable; and (2) whether compensation from a current corporate employer may include amounts to compensate petitioner for prior unfunded pension costs as a self-employed individual; i.e., under-compensated past services.

Neither of respondent's objections assail the first question of examining self-employment earnings to decide the reasonableness of current corporate employee compensation. Instead, both objections seek to prevent a successor entity from deducting currently amounts which are attributable to services performed for a prior separate taxable entity.

As to the first question, we find that it is proper to make reference to prior self-employment earnings to decide whether current corporate compensation of an employee is reasonable. As discussed above, respondent points out that in section 1.401-10(b)(3)(i), Income Tax Regs., "employee" as used in section 401 does not include self-employed individuals when the context in which it is used dictates otherwise. However, the Code itself does not set forth standards for determining the reasonableness of an employee's compensation.⁵ Section 1.404(a)-1(b), Income Tax Regs., does not specifically disallow reference to prior self-employed earnings in determining reasonableness of a corporate employee's compensation. A plain reading of sections 404(a), 404(a)(8) and 401(c)(1) supports a holding that a self-employed individual should

⁵The limitations of section 404(e) are unrelated to considerations of reasonableness.

be considered an employee for the limited purpose of determining reasonableness. It cannot be questioned that the clearest evidence of the worth of petitioner's services is petitioner's earnings from his dentistry practice as an individual proprietor.

The record discloses the following:

YEAR	NET PROFIT FROM PROFESSION	DIRECT CORPORATE		TOTAL COMPENSATION
		COMPENSATION		
1964.	. . . . .	. . . . .	\$47,620	\$ 47,620.00
1965.	. . . . .	. . . . .	38,039	38,039.00
1966.	. . . . .	. . . . .	53,246	53,246.00
1967.	. . . . .	. . . . .	62,450	62,450.00
1968.	. . . . .	. . . . .	72,735	72,735.00
1969.	. . . . .	. . . . .	75,702	75,702.00
1970 -	1/1/70 through 11/23/70.	. . . . .	81,473	
	11/23/70 through 11/30/70.	. . . . .	. . . . .	\$16,469.88
	12/1/70 through 12/31/70.	. . . . .	. . . . .	102,558.28
1971.	. . . . .	. . . . .	48,000.16	65,023.98
1972.	. . . . .	. . . . .	48,223.24	64,226.40
1973.	. . . . .	. . . . .	48,000.16	64,900.40
1974.	. . . . .	. . . . .	58,000.16	79,932.01

It is apparent that in 1970 petitioner's compensatory income was far in excess of the amounts he earned in prior years and amounts he was to be paid in subsequent years. Petitioner has offered no explanation for this difference.

On its face, the \$16,469.88 deferred compensation payment covering a 7-day period was unreasonable. Section 162(a)(1) of the Code requires that the services be "actually rendered," which precludes any contention that the deferred compensation payments were related to future services. Respondent has not invoked his powers under section 446(b) nor has he attempted to reallocate the deduction to petitioner under section 482.

On the authority of Lucas v. Ox Fibre Brush Co., 281 U.S. 115 (1930), petitioner contends that the deferred compensation paid in 1970 related to prior under-compensated years and should, therefore, be deductible. Section 1.404(a)-1(b), Income Tax Regs., is in agreement with Lucas v. Ox Fibre Brush Co., supra:

* * * a contribution which is in the nature of additional compensation for services performed in prior years may be deductible, even if the total of such contributions and other compensation for the current year would be in excess of reasonable compensation for services performed in the current year, provided that such total plus all compensation and contributions paid to or for such employee in prior years represents a reasonable allowance for all services rendered by the employee by the end of the current year. * * *

[Sec. 1.404(a)-1(b), Income Tax Regs.]

Assuming that petitioner's 1970 current and deferred compensation were reasonable, the tenor of the regulations assumes that the prior services of the employee were performed for the same employer. The same employer was involved in Lucas v. Ox Fibre Brush Co., *supra*.

Generally, the separateness of different taxable entities must be respected. Burnet v. Clark, 287 U.S. 410 (1932); Dalton v. Bowers, 287 U.S. 404 (1932). This case is not a proper one for establishing another exception to the rule. To the extent that the deferred compensation payment in 1970 represents payment for past under-compensated retirement benefits earned when petitioner was self-employed, we find that U.S. Asiatic Co., 30 T.C. 1373, 1380 (1958), controls our disallowance of the deduction. We held that corporate deductions were not allowable in respect to salary payments and reimbursements of expenses for periods preceding incorporation.

In R. J. Nicoll Co., 59 T.C. 37 (1972), we held that payments of compensation by a successor corporation were reasonable for current services and for services rendered by the shareholder-employee in prior years to the corporate employer's predecessor. The facts in Nicoll, although somewhat similar, are clearly and significantly distinguishable. During the early period of the expansion and development of the predecessor corporate business, the shareholder-employee and his brother chose

to leave as much money as possible in the corporation in order to provide funds for corporate expansion -- they were under-compensated and expected to be adequately compensated in subsequent years. R. J. Nicoll Co., 59 T.C. at 41, n. 4. Here, however, it cannot be contended that petitioner was under-compensated when he was self-employed. Petitioner presented evidence that he earned less than other dentists in the area but the best evidence of the value of his personal services is profit he derived from his own practice.

As a final issue, we must decide whether the 5 percent addition to tax under section 6653(a) is applicable. In his statutory notice of deficiency, the Commissioner made several other adjustments to which petitioner agreed. Petitioner also agreed to the assertion of the 5 percent negligence penalty as to those items. Petitioner's only ground to contest imposition of the penalty on the underpayment caused by the disallowed operating loss deduction is based on terms of the harshness of the result.

Section 6653(a) does not permit allocating the penalty to specific adjustments made to the return. If "any part of any underpayment" is due to fraud, the addition to the tax shall be imposed. Mensik v. Commissioner, 37 T.C. 703 (1962), affd. 328 F. 2d 147 (7th Cir. 1964), cert. denied 379 U.S. 827 (1964). The fraud

penalty applies to the difference between the correct tax liability as redetermined and the tax liability reflected on the return. Bennie F. Stewart, 66 T.C. 54 (1976); M. William Brennen, 66 T.C. 61 (1976). Both the fraud and negligence penalties are contained in section 6653 of the Code and contain identical language; if any part of the underpayment is due to fraud (negligence). We are presented with no reason as to why the rule as to the negligence penalty should be different from the rules as to the fraud penalty. Therefore, the negligence penalty must be imposed on the deficiency before us.

Decision will be entered
for the respondent.

ANGELO J. and IDA A. BIANCHI,)
 Petitioners,)
)
 v.) Docket No. 8152-74
)
 COMMISSIONER OF INTERNAL REVENUE,)
 Respondent.)

Pursuant to the determination of this Court as set forth in its FINDINGS OF FACT AND OPINION filed May 20, 1976, it is

ORDERED and DECIDED: That there is a deficiency in income tax due from petitioners for the taxable year 1970 and addition to tax due from petitioners under section 6653(a) of the Internal Revenue Code in the amounts of \$9,554.75 and \$477.74, respectively.

(signed) William A. Gorfe
Judge

ENTERED: MAY 21 1976

76-4199

Docket No.

UNITED STATES COURT OF APPEALS for the
SECOND CIRCUIT

-----x
ANGELO J. and IDA A. BIANCHI,
Petitioners-Appellants,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.
-----x

~~BRIEF FOR PETITIONERS-APPELLANTS~~

APPENDIX

WINTHROP DRAKE THIES
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Tel: 201/676-9300

TO: Court of Appeals for the Second Circuit, Attn: Clerk
Scott P. Crampton, Esq., Ass't Attorney General, Tax Div.,
U.S. Department of Justice, Attorney for Respondent-Appellee